THE IMPACT OF

FEDERAL TAXES

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To

MY FELLOW STUDENTS OF TAXATION
IN THE COLUMBIA LAW SCHOOL

PREFACE

MANY BOOKS have been written on the interpretation of the provisions of the major federal tax laws. As the statutes have increased in length and technicality, in large part because of the desire of Congress and the Treasury to deal justly with special situations presented to them, the treatises and tax services have more than correspondingly expanded. One result is that, while the specialist is provided with better tools in this field than in nearly any other, the businessman and his lawyer find it increasingly difficult to obtain any comprehension of federal taxation in its broader and more fundamental aspects. Why are income taxes heavily utilized, why is the general sales tax shunned? What forms of capitalization are encouraged, what kinds of family settlements discouraged by the indirect but potent sanctions of the tax system?

This book is an inquiry into questions like these. It is in the nature of a preliminary study, for much more could be written. It was written now, because these questions have great significance, now that tax rates have reached an all-time high, and may well reach greater heights. The book is not designed at all to compete with treatises which interpret the law, nor with general works on public finance. The intention is primarily to consider the tenets on which a tax system should be based, and some of the principal effects of the major federal imposts.

Common prudence might dictate the postponement of any book of this sort until the war is over, and we can view in retrospect the wisdom of the changes in the federal tax system enacted to meet the needs of this greatest emergency. A scholar could delay his judgments, but in this case a legislator and a businessman cannot. Taxes must be collected and paid day after day. A decision in Congress even to maintain the *status quo* will have great repercussions. A determination to lower an exemption here; to increase a rate there; to add this new Victory tax or that spendings tax to the system affects vitally the family and business lives of millions of people.

Expediency and gross revenues produced are poor guides to fairness in taxation, even in wartime. The government owes it to itself to encourage citizens to produce to maximum capacity. A badly designed tax system, however much it may yield, can be a serious brake on incentive. Ours, with the best intentions, is beginning to function as a brake today. Hence, it is certainly worth while to consider, as best we can, how a fairer and more adequate tax system may be constructed which will be as little harmful as possible to the economy we fight to preserve.

The book was written at a bad time. Not only is the progress of the war first in our minds, but Congress completed a major revision of the revenue laws while the manuscript was being prepared. It would be amazing if errors in statement have not crept in somewhere. If they have not, much of the credit is due to Professor Carl Shoup, of Columbia University, Clifford H. Domke, Esq., of the New York bar, and John O'Brien, Esq., of the Washington bar, who were good enough to read various chapters in manuscript and proof. Finally, I am grateful to the respective publishers of *Fortune,* the *Journal of Accountancy,* the *Proceedings of*

the Academy of Political Science, and of the *University of Chicago Law Review, Columbia Law Review* and *Texas Law Reviews* for permission to utilize material from articles which originally appeared in their publications.

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CHAPTER I

A FEDERAL TAX PROGRAM

CONFRONTED with federal taxes which have increased every year for ten years and which seem to need still greater increases, the ordinary citizen has become a bit bewildered. He understands the need for tremendous sums of money to fight a world-wide total war. Since few men really comprehend a billion dollars (which has no place in an individual's economy), the citizen is perhaps not much more concerned over the increase in federal expenditures from the seven billions of 1935 to the estimated $77.5 billions of 1943 than he would be in a revision upwards of the distance in light years from the earth to Betelgeuse. But in the light of his experience with his own budget, he is somewhat alarmed that federal expenditures so greatly exceed federal receipts, and that the federal debt has reached such incredible heights. On the whole, however, he is not too much worried by his inability to fathom the vast complexities of federal finances; he does not expect to understand military strategy on a hundred fronts either.

Taxes themselves do concern him—not the total individual income-tax collections, but the amounts he himself will have to pay on March 15 and every succeeding quarter, or the amounts which may be withheld from the salary he uses to pay for rent, food, clothes, education. He is willing to pay all the taxes he can,[1] for he surely believes "this is worth

[1] Of course in these times, he and the Treasury may well disagree on how much he *can* pay.

fighting for." In his daily life he meets or hears of many sorts of taxes—those on corporations, sales, estates and gifts, admissions, telephone messages, railroad tickets, and so on. He even reads statements that vastly more money could be raised if this new tax were used, or that old one really put to work. Is there any rhyme or reason in the system? Are there any guiding principles by which the Treasury, Congress, or the humble taxpayer can judge whether the government is performing this major function wisely and fairly?

The shattering of so many shibboleths in the past quarter century has left him a little doubtful whether there is any better guide to tax policy than expediency. The Treasury has hardly given him any better lead. Recent tax bills in general have sought to tap each of the possible sources of funds, with some conspicuous exceptions. Although the Secretary has talked about the undesirability of business taxes so high as to injure the economy permanently, there has not been much discussion of the fundamental bases on which the proposed tax structure was being organized. In general, for all that the 1942 tax law was one of the largest in history, the existing system was maintained, though with sharp increases in rates, and technical changes to remove hardships or loopholes. Treasury representatives have occasionally urged the elimination of "special privileges"—the "privilege" enjoyed by husbands and wives of filing separate tax returns, each reporting his own income; the exemption accorded state and municipal bond interest, and the special percentage-depletion deductions granted to owners of mines and oil wells. But if all these "privileges" were eliminated—and there is a good deal of doubt whether some of them should be—the results, either in revenue or in increased tax equity, are inconsiderable in reference to the total problem.

In other words, the Treasury has not advocated recently any fundamental changes in the structure of our tax system,

other than, perhaps, its recommendation of a spendings tax. If the system is basically sound, this is wise policy. War time requires so many readjustments that we might well be spared this one. Moreover, under a government of separated powers, the formulation and passage of a tax bill are always matters of study, conference, and negotiation on a major scale, between the President, the Secretary of the Treasury, his legal, economic and statistical staffs, officials of the Bureau of Internal Revenue, members of the Ways and Means Committee of the House and the Finance Committee of the Senate, and the experts and draftsmen for the committees. A good job of revision requires about a year, altogether. The Treasury and Congress may be pardoned for wishing to cut down the proportions of the task as far as possible. On the other hand, in so far as the current tax structure is defective, severe increases in rates accentuate the defects. No one needed to adjust his business policies greatly on account of the 1 percent normal tax and 1 to 6 percent surtaxes originally imposed by the 1913 Act. A corporation tax of 40 percent, plus a confiscatory excess profits tax, is another matter. Such a tax can drive taxpayers out of business or into policies or adjustments that will plague the state for some time to come.

No one can doubt any longer that federal taxes will remain high for a long time. Now we have the unprecedented expenses of a truly world war. When it is over, we will have the almost equally heavy expenses of a world requiring reconstruction. After the war, our physical assets in the way of factories, mines, oil wells and farms will presumably be the least devastated of those belonging to any great nation. Lend-lease will not stop with the armistice. Our humanitarian good sense will lead us to vast expenditures to succor distant peoples and to restore distant lands. Certainly our trade will not retreat within our own borders. We must do

business in many places, often on such a scale that government regulation, financing, participation will be inevitable. Our military and naval establishment will not soon shrink to the size of the twenties.

Meantime government activities and expenditures at home will surely exceed those of the thirties, whether or not we do much in the way of retiring our debt. Industry and the individual alike will require a good deal of help, and the government will be expected to provide much of it.

In the fiscal year 1914, the United States spent about one billion dollars; in 1924, when we had thoroughly settled down after World War I, federal expenditures were just over four billions, four times as much. In 1939, the national government spent $8,707 millions. We can hazard as the roughest sort of guess that the postwar level of annual expenditures will run around twenty billions of dollars. To pay that bill, without serious injury to the economy, will require a tax structure devised with the greatest skill, to be fair, adequate, and practical to administer.

It is not too early, therefore, for us to consider what the attributes of a good tax system are. This is no abstract study, for the next consideration is how well or how poorly our present system conforms to these canons. Finally, what changes to improve the structure are indicated? In this chapter, attention will be directed almost wholly to fundamentals, not to the thousand and one special provisions to do equity in particular cases. On the whole, we have probably spent too much time on minor loopholes and minor cases. That is one good reason why our tax law becomes technically more complicated and unintelligible every year. It will be a pleasure to leave the exposition of these matters to the encyclopedic textbooks and tax services. This chapter will be devoted to first principles, which anyone can understand;

which are so generally accepted that sometimes we forget to apply them.

Criteria of a Well-Designed Tax System

A. A well-designed tax system[2] should provide an adequate yield. This proposition is self-evident. It requires only one explanation. Adequacy is not merely a matter of mathematics. It also involves dependability. The yield of the system as a whole should be reasonably dependable in bad times as well as good. To insure stability of yield, there should be diversity in the kinds of taxes imposed, so that the fiscal disappointments of one (say the income tax) do not completely demoralize the Treasury. Finally, if a group of taxes is to serve the state adequately, it must be possible in times like these not merely to maintain but to increase its yield to meet fiscal needs, without too serious disturbance of the business and social structure.

B. A well-designed tax system should be simple and economical in administration. This proposition also explains itself. A tax which can be imposed in understandable language and collected with relative ease, such as, say, the tobacco tax, has important advantages over one which requires elaborate provisions and administration, such as the income tax or the excess-profits tax. If the computation of the tax is expensive and full of uncertainties, if numerous conferences and much litigation are required to arrive at the exact liability, so that business cannot reasonably forecast this item of its operating expense, the tax is obviously less desirable to the taxpayer and ultimately to the community than one which costs him less to pay.

C. A well-designed tax system should be fair. This prop-

[2] Some of this material is taken from an article in FORTUNE, *The Too Well Remembered Man* (April, 1935). Reprinted by permission of the publishers.

osition, though superficially obvious, requires some discussion. Fairness, which is approved by all men in theory, is not always approved by all men in fact. Abstract equity may look like practical discrimination when applied to the particular case. For all of us have a human habit of defining equity in the concrete with a view to our individual circumstances. The actual distribution of the tax load is a matter of the most immediate concern to the individual—a matter which may easily mean the difference between success and failure in his business. And he finds it difficult to accept as equitable and just a burden which his business finds it difficult to bear.

How can fairness be determined? Is it fair to place over 80 percent of the burden of the income tax on the shoulders of that minority of our citizens whose net incomes exceed $5,000 per year? Almost certainly the minority does not think so. As among such citizens, is it fair to take 20 percent of the total net income of a single man with a salary of $5,000, and over 50 percent of the total net income of a man with a salary of $50,000? Such a degree of progression in the rate schedule probably seems fair enough to persons with incomes of $5,000 or $2,500. Or, to view the problem from another angle, what equitable standards did, or should, Congress apply in determining that sales of some sixty commodities should be subjected to various kinds of excises, and sales of other commodities should not? What brings beer, cigarettes, and gasoline within the charmed circle, and excludes fruit juice, candy, and salt? What should determine the degree of progression of a rate schedule? Has a conscientious Congressman any better guide to equity than the number of taxpayers of each of the different classes within his district?

It is evident that we shall have to take our standards of equity from those who can afford to be objective. Unfortunately, it is almost as evident that standards of fairness,

like standards of beauty are not susceptible of measurement with mathematical precision. Moreover, reflection shows that our ideas of what is fair in taxation are likely to change with the times, curiously enough; and, like Justice Holmes's common law, are not a brooding omnipresence in the sky. A tax on inheritances or on incomes 200 years ago would no doubt have been regarded as monstrous, certainly if imposed at our present rates. Today a middle-class Englishman pays one third or more of his income to the state, and apparently would be delighted if the normal rate could be reduced to 25 percent. Ten years ago a middle-class American would have regarded himself as grossly abused by a tyrannous government if these rates had been applied to him.

But although mathematical standards of fairness are elusive, the broad outlines of equity in a tax system have been more or less agreed upon, at least by economists, through a consideration of the basic problem of the relation of the individual to the state, and the contribution which he can therefore be expected to make to it. Two theories relative to this problem have had the greatest currency—that taxation should be proportional to benefits received; and that taxation should be proportional to ability to pay. A subsidiary dogma is that every citizen should make some contribution, however small, to the state.

The first theory of fairness is that taxation should be proportional to benefits received. The first proposition takes account of the fact that the state provides certain benefits for its members, such as good roads, public education, free seeds, or the WPB; and suggests that the taxes a given citizen pays are compensation for services the state renders to him. The gasoline tax in its earlier stages, when its proceeds were in fact devoted to the improvement of roads, is a good example of the application of the benefit theory.

This theory works well enough to justify some forms of

taxation, but is hardly a complete explanation. Thus the general property tax in New York yields 60 percent of the total revenue collected: in 1940 $824,000,000 out of a total of $1,358,000,000. In so far as the proceeds are used by the state for police and fire protection, it seems at first glance that the property tax is in effect a premium paid by citizens for a form of insurance on their lives and property and hence may properly be levied in proportion to the value of property protected. But the state, particularly in these times, furnishes many other services to taxpayers and nontaxpayers alike; and the benefits a particular citizen receives are not necessarily proportional to the property he owns, certainly not to the real property. In fact, the wealthy man is likely to provide for himself many of the services supported by public expenditures, such as free schools, so that these direct benefits to him from the state are not only no greater than those of the poor man, but actually less. Moreover, it is unlikely that in fact the police protection afforded the Empire State Building or Rockefeller Center is one hundred times as great as that afforded to a building on Fifth Avenue worth one one hundredth as much. The fact that the state provides other benefits than these obvious ones merely tends to reinforce the conclusion that the concept of the state as an insurance company is too rudimentary. The total taxes the individual pays to it are certainly not in fact apportioned according to benefits received, and it would probably be difficult or impossible without much airy reasoning to justify many individual tax bills on this basis today. Nevertheless, this theory does afford a reasonable justification for some taxes, and it need not be discarded wholly because it does not seem to cover them all.

The second theory of fairness is that taxation should be proportional to ability to pay. This theory is a more modern conception. Poor and wealthy alike are members of a com-

munity with a common destiny. All may fairly be called upon to contribute to a common fund for the advancement of community welfare. In determining the amount of contributions to the fund, it is generally desirable that the strong should contribute more than the weak. How much more?—in proportion to aggregate wealth, or to aggregate income, or at rates progressively higher as income or wealth increases? Here are possibilities of many refinements—of the source of the income, earned, or unearned; the time within which it was accumulated; the expenses which must be allowed, and so on. But speaking generally, economists seem to be fairly well agreed that income is as adequate a single measure of capacity to pay as we have, and that as income increases, capacity increases more than proportionally. Furthermore, there seems to be fair agreement that, although in the interests of a diversified tax system it will not be possible to levy all taxes on this basis, at least the major imposts should be justifiable as corresponding fairly with ability to pay them. The federal income tax and estate tax with their progressive, not proportional, rates have their justification on this footing.

The Present Federal Tax System Judged by These Criteria

These three criteria—adequacy, simplicity and economy in administration, and fairness in distribution—are, of course, not all the yardsticks that might be applied to a tax system. Another desideratum is that the tax system be so designed that it will stimulate, or at least permit, the economy to make the best use of its resources. Several of the succeeding chapters are directed to one aspect of this point—whether the tax laws, in encouraging and discouraging various forms of property disposition, are accomplishing socially desirable results. Nevertheless, the three principal standards

are sufficient to give us a satisfactory measurement. How does the present federal tax structure stack up from these three points of view? It should be emphasized, perhaps, that this article is not a primer on expenditures, but on taxation. Whether present or future federal expenditures should be diminished or increased is not our problem here. Our point of reference in judging the adequacy and fairness of the present tax system must be the present program of federal expenditures.

A. The present federal tax system is not simple or economical in administration. It will not be news to the income taxpayers of the country to be told that the federal tax laws lack simplicity. Their complication, turgidity, and Alice-in-Wonderland phraseology have been parodied by every cartoonist in America. The reason for the complication is not the stupidity of Congressmen, but rather their overwhelming desire at once to be just even in the smallest, least usual case and to be astute in fitting a specific plug into every loophole that ingenious attorneys and accountants may have discovered. Our tax laws have been skillfully drafted, for Congress for twenty-five years has relied upon the expert assistance of a permanent corps of legislative counsel. But brave endeavors to draft specific statutory provisions to fit each of the parts of the complex business and social mechanism have left their tortuous scars. The income-tax law in particular has grown so involved that only specialists can understand it, and few of them can make an intelligent use of it.

The estate-tax and excess-profits tax sections equal or exceed in complexity the income-tax provisions. On the other hand, the miscellaneous excise and sales taxes, though not always models of clarity, inspire little litigation and apparently are reasonably cheap to administer. This is partly due in some cases to the fact that the provisions are of long stand-

ing. Moreover, some of the major revenue producers, the taxes on liquor, tobacco, and gasoline, are collected from comparatively few corporations under a system of close supervision from the beginning of the manufacturing process to its conclusion. From the nature of things, excise and sales taxes are apt to be cheaper to administer than direct taxes on incomes, and their provisions can be simpler. For example, a general retail sales tax would be less expensive to collect, certainly in proportion to revenue produced, than an income tax or spending tax on small wage earners.

But no one would wish to see the tax system converted into one wholly on sales and the like. For reasons more fully developed in the next section, taxes directly geared to capacity to pay, of which the income and estate taxes are prime examples, are and ought to be the cornerstones of our structure. Can anything be done to simplify these taxes? In the hands of a competent, permanent, well-paid personnel, a much simpler law drawn in more general terms, conferring wide powers upon Treasury officials to make rules to fit special as well as general cases, would be a possible and salutary improvement. The application of the rules in particular cases would be subject to judicial review as at present. The problem of personnel, however, conditions any such proposal. The revenue service is not manned by a competent, permanent, well-paid personnel at present. Since the top positions are not filled as a matter of course by promotions from the ranks, since the pay is not very good, nor the tenure secure, particularly in the better positions, the revenue service is not very attractive even to men who might be content otherwise to turn their backs upon the gamble for higher stakes in the business world. The collector of internal revenue, theoretically the keystone of the system, is a political appointee normally with no experience in the specialized technique of revenue administration; and two thirds of the

men in his office are freely appointed by him, with no civil-service requirements. It is a curious commentary upon the American political scene that we are so slow to require technical competence in technical governmental positions, though so quick to require it in similar positions in business. There is, of course, a large civil-service personnel in the Bureau which does most of the detailed work of assessment and collection; and contrary to the winds of gossip, the enormous majority is honest, and more competent than one would reasonably expect from the salaries paid and opportunities offered. Moreover, the men occupying the posts just below the political appointments at the top are largely career men of excellent capacities. Nevertheless, the revenue laws and their administration cannot be greatly simplified until the Treasury and the public visualize the revenue service as a permanent career for men of good education, who have sufficient security of salary and of tenure to retain them in it in spite of any siren calls of business or private practice.

The cost to the government of collecting internal revenue in the past five years has ranged from $1.39 to 89c per $100, a low average cost. But these figures are small comfort to tax-paying businesses compelled to spend an increasing amount of time on tax problems that might better be spent on problems of production. Moreover, the sheer out-of-pocket expense of compliance with tax laws, of attorney's and accountant's fees, is enormous. A large corporation may easily be required to spend fifty or one hundred thousand dollars in computing its invested capital for excess-profits tax purposes, only the beginning of a long battle to settle tax liability. The excess-profits tax law is highly specific, yet most of the major questions arising under it cannot be solved with certainty by an accountant or lawyer, much less by corporate officers themselves. We have years of unproductive controversy and litigation ahead in this field alone.

The Bureau of Internal Revenue in 1938 undertook to improve the administrative process, by transferring much of its trained personnel from Washington to ten regional offices scattered over the country. These offices were empowered finally to pass upon and settle income, estate, gift, and excess-profits tax controversies; or in the absence of settlement, to try them before the Board of Tax Appeals.[3] Thus taxpayers have an opportunity to discuss and settle disputes in the localities where their books are located, and to settle them on a reasonably informal, give-and-take basis. Of course no formal program of decentralization can eliminate all the expense and complexity in tax administration, but the present plan, intelligently and fairly administered, can result in great savings both to the Treasury and the taxpayer.

It is problematical how much the tax laws themselves can be simplified. The British laws seem to be better administered, largely because the entire personnel are well-trained, adequately paid civil servants; but in terms the statutes are no less involved than our own. Nevertheless the project gives enough promise of success to be worth concerted effort, if our draftsmen ever have time enough between routine revisions to undertake it. The new code should be bottomed on two balancing premises: that corporate income statements, certified by reputable accountants, will be accepted for tax purposes unless demonstrably inadequate or false; and that the statute shall be composed, so far as possible, of simple statements of general rules, to be supplemented by official regulations. The consolidated return provisions have followed this general line and the gift tax law is a further example. Even the consolidation of provisions into the Internal Revenue Code, without change in substance, was

[3] The 1942 law changed the name of the Board to The Tax Court of the United States. In this book, the organization is referred to as the Board, when the reference is to it and its work prior to the effective date of the 1942 law.

most helpful. The proposed Internal Revenue Administrative Code, a revision and codification of provisions, many of them quite archaic, will when finally adopted be another good move in the interests of simplicity and economy. What is mainly needed for the larger task is determination on the part of someone in authority to undertake it and see it through, plus the organization and maintenance of the expert staff required. It is certain that their efforts would be fruitful, even if the brightest hopes of their supporters could not be realized.

B. The present federal tax system is inadequate. During the fiscal year 1942, total budgetary receipts of the federal government reached $13 2/3 billions, an all time high. Total budgetary expenditures, however, did even better. They were not quite $32.5 billions, leaving a deficit of over $19.5 billions (after adjustments). In addition, government corporations (chiefly the R.F.C.) spent $3.5 billions more than they received, and the Treasury increased its cash balance. Thus the public debt increased by nearly $23.5 billions. The total debt, including guaranteed obligations, was nearly $77 billions at the end of the year. Ten years ago it was about $19.5 billions, twenty years ago about $23 billions.

The picture of the fiscal year 1943 is even worse. The revised budget estimates of April 24, 1942, contemplated expenditures of $77.5 billions, and receipts of $23.9 under the tax system then existing, supplemented by $7 billions from the 1942 tax law. So, while the Treasury expects to collect at least $10 billions *more* in taxes (nearly doubling the 1942 record), we are farther than ever from balancing the outgo—nearly $54 billions shy. The receipts under existing tax laws will not equal one third of the expenditures.

Although adequacy cannot be determined wholly on a mathematical basis, prima facie this is a record of extreme

inadequacy. The Treasury thought so, too; for on succeeding occasions in 1942 it recommended increases totaling in the end about $15 billions. The tax structure is inadequate, first, because too much borrowing will be required. Even if individuals buy bonds at the rate of a billion a month, the Treasury will still have to raise tremendous sums from banks and insurance companies already loaded with government securities. Even with current low interest rates, the charges for debt service alone will soon exceed two billions a year, a tidy item even in the federal budget. We would do well to pay more than a third of the costs of this war as we go, while incomes and purchasing power are high, while there are the most obvious reasons for supporting the government to the full.

Again, the tax structure is inadequate because, with expenditures at a peak, we are not exploiting known sources of revenue as much as our citizens expect. There can be little doubt that all of us are prepared to make severe sacrifices in the interests of preserving our liberties and our civilization. Some of the population, but really a small minority, is feeling the pinch, but the majority is not. Even in 1942, with lowered personal exemptions, only 17,688,219 individual income-tax returns were filed, and of these, 8,617,981 showed no tax due. To be sure, there are a wide variety of sales taxes, some of them (on liquor and tobacco, for example) at high rates. But most of these are of long standing; most smokers are unconscious of the high tax wrapped up in a package of cigarettes. None of the sales-tax increases have been so high as to be as obvious to the consumer as, say, wartime regulations and the general increase in the cost of living. Gasoline rationing has undoubtedly had more effect so far on the modes of life of more citizens than has the tax system. This is not to say that anguish to the citizen is a

fundamental of taxation. It seems clear, however, that citizens are prepared to stand heavier taxes than Congress was prepared to levy, at least in an election year.

If we really want to head off inflation, selective taxation is an intelligent means to the end. "Selective," because not all taxes operate to stem the tide of increasing incomes bidding for consumer goods. Thus, our corporation taxes are exceptionally heavy, yet they are of secondary use in narrowing the so-called inflationary gap, for corporation income is not much used to bid for scarce articles of consumption. A sales tax operates directly to cut down purchasing power *pro tanto;* and so do income taxes. Since the great increases in income have been at the lower levels, on this score an increase in the normal tax rather than increases in surtaxes is indicated. England has followed this course, with a normal tax of 50 percent (as compared to our 6 percent normal tax and 13 percent surtax) except at the very bottom of the scale, where the rate is 32.5 percent.

There has been much discussion of a general sales tax, collected either from manufacturers or retailers. It would produce a great deal of money, though not so much, perhaps, as some of its advocates would like to believe. Still the Treasury tells us that a 5 percent tax on all retail sales (except sales to government) would yield $2.5 billions. The Treasury has objected to a sales tax on grounds of tax equity and administrative difficulty—questions to be considered later. But whatever the demerits of a sales tax in these respects, the Treasury has found it hard to convince a thoughtful citizen that it is intensely concerned about the adequacy of its tax revenues, when so great and so obvious a source is passed by.

One aspect of adequacy is diversity of kinds of taxes, so that great shifts in economic conditions will not empty the Treasury. We had this type of experience in the beginning of the 1930s. Not only were revenues entirely inadequate,

but the forms of taxes mainly utilized were not well designed to produce satisfactorily during a depression. Just now we are imposing a wide variety of taxes, nearly all the major forms except the general sales tax. By lowering exemptions, more and more citizens have been brought within the income tax. Estate and gift taxes are still not very broadly applicable, but they are available for greater use. So are the many forms of miscellaneous excise and sales taxes. The Treasury has plenty of kinds of taxes on the books. Few additional forms would be advocated; standard recommendations would be for variations in present modes, such as the general sales tax to supplement or to substitute for some of the specific sales taxes, and an undistributed profits tax to be linked up with corporate taxes.

The real problem is, then, which forms of taxes should be employed? What principal changes should be made in them? This is a question of the equitable distribution of the tax burden—and a very difficult one to answer. It will be considered under the next subdivision.

C. The present federal tax system is in general well-balanced, but the method of taxing corporate income is grossly unfair. Whether or not the present system is equitable depends largely upon what the actual distribution of the tax burden is. With the great variety of taxes which we have, some direct, some indirect, it is an extremely difficult task to work out the actual distribution of the tax burden over the various income classes. Studies of this kind have been made in this country by the Twentieth Century Fund *(Facing the Tax Problem)*,[4] and in Great Britain by the Committee on National Debt and Taxation in 1927. Unfortunately these studies do not reflect present levels of taxation. Whatever the distribution at present may turn out to be, it would be

[4] See also Colm and Tarasov, *Who Pays the Taxes?* (Temp. Nat. Econ. Comm., Monograph No. 3, 1941).

well for each of us to be conscious of his individual burden, and the burden of his neighbor. How can anyone tell, for example, whether a general sales tax, regressive as it may be, can properly be added to our tax system, without knowing approximately how much different income classes are now paying, and what they would pay if such a tax were added to or substituted for some of the present special excises?

During the fiscal year 1942, the Treasury collected nearly $8 billions, out of a total of $13 2/3 billions, through the income tax, individual and corporate; over $1 billion through employment taxes; $282 millions through the capital stock tax; and $433 millions through the estate and gift taxes. In other words, some 73 percent of total internal revenue was collected by means of taxes designed to measure capacity to pay in one way or another. In 1933, the corresponding percentage figure was 48.2; in 1937, it was 62.1. The additional tax collections (which rose from $1,619 millions to $4,634 millions and finally to $13,667 millions) were largely accomplished through increases in the income tax. Since taxes of this type are generally regarded as the fairest, the general shift in this direction has been salutary. How much further should it go? Few would urge that, even in theory, the tax system should be made up solely of income, estate, and gift taxes. These taxes are complicated and expensive to administer, particularly when applied to small taxpayers. Returns from them also fluctuate greatly; in times when the national income is large, they produce very well, but during a depression, their yield is disappointingly small. On a rule of thumb basis, a tax system utilizing income, estate, and gift taxes for three fourths of its revenue and sales taxes and excises for the other fourth is generally well balanced in its sources of revenue. It would follow, at least as a working hypothesis, that the necessary additional revenue might be raised by tax

additions and increases which would preserve this ratio more or less.

Working on this hypothesis in the formulation of a more detailed program, we must consider whether substantial additional revenue can be obtained through each of our present major taxes, and how. The individual income tax is first in line for analysis.

A Federal Tax Program for the Future

INDIVIDUAL INCOME TAX

The 1942 revenue act provides a normal tax rate of 6 percent on income in excess of exemptions of $1,200 for married couples, $500 for single persons, and $350 for dependents. There are further allowances for earned income and for certain federal bond interest. The surtax rates start at 13 percent of net income in excess of these exemptions. An optional short form of return is provided for individuals with *gross* incomes of $3,000 or less from earnings, dividends, interest, or annuities. Consequently, a single man earning $1,500 income will be called on to pay $162 if he has no dependents. A married man with the same income and no dependents will pay $29. A married man with two children under 18 pays no income tax until his gross income exceeds $2,070, when he owes $1.

At the level of $5,000 net income, a single man will pay $920; a married man with no dependents $746; and a married man with two children $592. At $10,000, the figures are, respectively, $2,390, $2,152, and $1,914. These figures indicate that the income tax has become an important item in the household budget, except in the lowest brackets. Moreover, heavy increases in income tax have occurred in a short span of years, as the table below shows:

Status of Taxpayer (All income earned)	*1938*	*1941*	*1942*
$1,500 net income			
Single person, no dependents	$14.	$69.	$181.
Married couple, no dependents	0.	0.	48.
two dependents	0.	0.	0.
$2,500 net income			
Single person, no dependents	50.	165.	365.
Married couple, no dependents	0.	90.	232.
two dependents	0.	12.	99.
$5,000 net income			
Single person, no dependents	140.	482.50	920.
Married couple, no dependents	80.	375.	746.
two dependents	48.	271.	592.
$10,000 net income			
Single person, no dependents	560.	1,492.50	2,390.
Married couple, no dependents	415.	1,305.	2,152.
two dependents	343.	1,117.	1,914.

The Victory Tax imposed by the Revenue Act of 1942 (§172) has not been included in these computations since it is not calculated on the same basis as the income tax. It is a 5 percent tax on income, defined somewhat differently from the net income subject to the regular income tax. The tax is originally withheld at the source but is subject to correction in a return. Current credits are allowed for life-insurance premiums, payments on indebtedness, and purchases of United States obligations. In the case of a single person, the credits may not exceed $500, or 25 percent of the tax, whichever is the lesser. In the case of a married person, the credit may not exceed 40 percent of the tax or $1,000, whichever is the lesser; plus 2 percent of the tax or $100, whichever is the lesser, for each dependent. Like credits will be allowed after the war, to the extent that they have not

been used up currently. Aside from the credits, the Victory Tax on a married couple without dependents having $2,500 net income would thus approximate $125; at $5,000, it would approximate $250; and at $10,000, $500, in addition to the income taxes shown.

The story in the upper brackets differs in degree. These taxpayers have long paid substantial taxes; rates have been substantially increased, and a much larger proportion of total income goes for taxes than in the middle and lower brackets. To illustrate with the case of the married man with no dependents, here are the figures:

Net Earned Income	*1938*	*1941*	*1942*
$25,000	$2,489	$6,864	$9,220
50,000	8,869	20,439	25,328
100,000	32,469	52,704	64,060

In passing, note that, if the $25,000 man doubles his income, he receives about $9,000 out of the next $25,000, and pays $16,000 to the Treasury. If he then becomes president of the company at $100,000, out of the additional $50,000 income he keeps for himself $11,268 and pays to the Treasury $38,732. Nearly two thirds of his whole salary and more than four fifths of the last $10,000 is, in substance, held in trust for the Treasury.

These figures show why the proposal to limit all incomes to $25,000 has no great fiscal significance. The Treasury estimated that the proposal would yield about $181 millions. In other words, there is not much gold left in the higher income peaks; what there is, is in the hills. More revenue can be obtained by income taxation from the lower and lower middle brackets. It could be obtained by a still further increase in the normal tax applicable to all income taxpayers, but is particularly effective as applied to the lower income groups.

The British have long imposed a much heavier normal tax than we have, and relatively less heavy surtaxes. Their current rate is 50 percent, except in the very lowest brackets, where it is 32.5 percent. The key to the collection of so heavy a tax from persons of modest incomes is withholding at the source of payment. The British employ withholding so broadly as to collect from half to two thirds of the income tax in this way. Withholding reduces administrative dependence on returns filed by many small taxpayers. This is an important administrative advantage, for in the lower brackets mistakes are likely to be frequent and correction of mistakes more expensive than it is worth. Again, there are practical advantages to the taxpayer himself in having the tax deducted from his income before he receives it to spend. For one thing withholding reduces the burden on a widow of paying a debt to the government after the income has ceased. There is general agreement that we should institute the withholding system at once, in the collection of the ordinary income tax. An elaborate system of withholding has been provided for the 5 percent Victory Tax. The one question is how best to do it—how to alleviate or to avoid doubling up on tax payments during the initial year. These difficulties are not insuperable. The plan can be introduced gradually; or taxation might be put on a current basis by treating all payments in 1943 as payments of tax on 1943 and not 1942 income.

By employing several stringent modifications, the individual income tax might be made to produce several billions more. The amendments would include a normal tax of 25 percent, collected at the source on current income. Surtax rates would be reduced in the lower brackets to eliminate the absurdity of a surtax on a $1,000 income. They would start at 4 percent at say, $3,000 or $4,000 net income. The credit for dependents would be reduced to $200 or $300.

With rates at these heights, in order to build up a reserve for ourselves and our families we need more adequate allowances to meet the fixed charges we customarily incur—insurance premiums, amortization payments on FHA mortgages, and savings in war bonds. Nearly all would agree that individuals should be encouraged to provide for their own security and that of their families; the government has arranged to carry some of this load, and may carry more, but individual provision to supplement state aid and to meet the particular situation is highly desirable. So long as income tax rates were comparatively low—only a few years ago a man with $5,000 net income paid $80 and a $25,000 man, $2,489—there was a surplus on the individual side of the account which could be and was employed in these ways. Now that surplus is greatly reduced, and may even be nonexistent. The credit for these charges need not be 100 percent to secure their continuance, but it ought to be enough to encourage contractual savings in these forms. One result will be, of course, to insure that such sums will not be expended for consumption, and thus will not contribute to the pressure for higher prices and inflation.

On the other side, in serious times like these, we ought to make sure so far as we can that all individuals are paying taxes on their actual income, neither more nor less. On this basis, several of the Treasury's recommendations in 1942 were wholly sound, though Congress did not adopt them all. For instance, alimony ought to be taxable to the recipient, not to the payor; the recipient gets all the benefits of the payment. Earnings in community-property states ought to be taxed on a parity with earnings elsewhere in the country. The theory that a movie actor in California with a $100,000 income, if married, should pay an income tax of $50,656 while a lawyer in New York with the same income pays $64,060, has no realistic basis, whatever its legalistic grounds.

Moreover, it would seem that persons receiving income from state and municipal bonds ought to contribute the same tax to the support of the Federal Government in this emergency as do their neighbors receiving like amounts from salaries, dividends, or interest from other securities. Granted that these bondholders contracted in peacetimes for immunity, should not that immunity, like other liberties, yield to the paramount demands of total war?

These are some, certainly not all, of the principal changes that need to be made at once in the individual income tax. A program of this kind will pinch, but with such a federal program of expenditures as we have, it is substantially the minimum.

CORPORATION INCOME TAX

A revision of the corporate tax structure in the interests of fairness will produce less aggregate revenue, not more. At present there is no correlation whatever between individual and corporate income taxes. Corporate income is subjected to high rates of normal tax and surtax ranging from a total of 25 percent of surtax net income below $25,000 to 40 percent if the income is over $50,000. (The surtax is essentially a normal tax, disguised to enable the taxation of interest on certain federal bonds, subject to a surtax only.) These rates are comparable to the individual rates, but the great inequity in the corporate tax system arises from the double taxation of income paid out in dividends. Dividends are taxed to the individual recipient like any other income, as salary or interest. But salary and interest are deducted by the corporation or individual who pays them; hence these items are taxed as income only once. Corporations are permitted no deduction or credit for dividends paid.[5] Hence

[5] Public utilities, however, were given by the 1942 law a credit against the surtax for preferred dividends paid.

the income which a common stockholder receives has already been reduced, almost halved, by the heavy income taxes paid by the corporation; he then pays the usual normal tax and surtaxes upon the dividends. Thus dividends are much more heavily taxed than interest or salaries; with the whole train of unfortunate consequences more fully described in Chapter IV.

The double taxation of corporate dividends should be stopped. As our income tax was originally adopted, the incomes of corporations and individuals were subjected to tax at the same normal rate. Dividends received by individuals were subject to surtaxes, but not to a second normal tax. In this way, income from investments in corporations was taxed at the same rates as salaries, interest, or other income. As time went on, the corporate normal tax was made higher than the individual, so that the credit the individual received against his normal tax did not equal what the corporation had paid. The discrimination against corporate dividends was not too serious, however, because the rates were low. In 1936, the credit was completely eliminated, as a feature of the undistributed-profits tax legislation. Since that time, the corporate normal tax and surtax, as well as individual rates, have increased enormously. The result is a tremendous double-tax burden on corporate income, greatly in excess of the taxes on any other form of income. This discrimination against corporate income is perhaps the most serious offense against fairness in the present tax law. Among its unfortunate corollaries, discussed in Chapter IV, are the heavy penalties against the incorporation of small enterprises and against the use of preferred or common stock in financing.

Equity could be restored by a return in substance to the original procedure: give a credit either to the corporation against its normal tax and surtax for the dividends it dis-

tributes, or to the individual against his normal tax for the dividends he receives. Either provision would, of course, cost revenue. If the former were adopted, however, much of the loss would be made up by additional dividends, subject to taxation to their recipients, and made possible by corporate savings due to the credit. But whatever the loss of revenue, the present scheme of taxing dividends twice and all other income once cannot be justified.

EXCESS-PROFITS TAX

This tax needs complete revision. The rates are so high that any defect in the tax is devastating, and unfortunately there are many defects. The "excess profits" subject to a confiscatory tax constitute the excess of current corporate income over either of two credits: (1) Average earnings for the period 1936–39; or (2) a percentage of invested capital ranging downwards from 8 per cent of such capital not over \$5 millions to 5 percent of that part of it which exceeds \$200 millions. Hence the first inquiry is: are corporate earnings in excess of these credits so clearly excessive that 90 percent of them should be taken by the Federal Government? The answer is negative, for several reasons. In the first place, average earnings for 1936–39 were certainly not normal in the case of many corporations. Moreover, this formula does not provide for the growth of business quite apart from the war. The law was amended in 1941 by the insertion of relief provisions, including an adjustment for growth. Broader relief provisions were inserted in 1942. In general, these provisions should be valuable in a limited number of special cases, but will not help much in the run-of-the-mill situations.

Next, invested capital is elaborately built up on the basis, not necessarily of the actual cost in money or securities of acquired properties, but of the predecessor's costs, if the property was obtained at some earlier date in a tax-free reor-

ganization. Depreciation deducted on income-tax returns ten, fifteen, or twenty years ago must be subtracted from invested capital, even though it is obvious today that that depreciation was excessive and that the property is worth much more than the basis as it stands on the tax books. In these ways, the profits or sins of ancestors of the present corporation and its officials are visited upon present stockholders. There is a sort of rough, or tax, justice in this treatment, but it is pretty rough. The tax advantages the corporation received from excessive depreciation, say in the twenties, was measured by rates only a fraction of those in effect today. The body of stockholders may have changed almost completely. In any event, it is evident that the tax indirectly borne by shareholders today bears no relationship to their individual investments or rate of return.

There are a number of less notable, but still serious, defects. One is the fact that the so-called excess profits subject to the tax are computed without a deduction for the corporate normal tax and surtax. A corporation has no earnings excess or otherwise, until it meets its charges, the first of which is its taxes. Under the present plan, the corporation is being subjected to an excess-profits tax measured in part by moneys it is obligated to pay the Treasury. Originally, it was not so; the normal tax was a deduction. The change was made primarily to secure more revenue. As a matter of fairness, the present scheme is wrong. Indeed, it can be contended more broadly that a corporation has no excess profits unless its income today, minus ordinary corporate taxes, exceeds its income for the base period of 1936–39, minus ordinary corporate taxes.

ESTATE AND GIFT TAXES

Although the estate and gift taxes together produce a fraction of the revenue of the income tax ($433 millions as against nearly $8 billions) they certainly exercise a more

profound effect on our economy than the tobacco and liquor taxes, which produce much more. Every considerable donative transfer of property by a person having a total estate in excess of the $60,000 exemption must be drawn with the taxes in view. The rates are high in the middle and upper brackets. Taken in conjunction with the income tax, it is hard to see how any man who starts from scratch can transmit to his children more than a moderate estate; only in an extraordinary case could it exceed one million dollars. Equity capital in the future must, it seems, come from many investors or from the government, not from a few capitalists.

Some of the legal repercussions of these two taxes are discussed in Chapter III. At this time, let us consider the general use to be made of them in the federal tax structure of the next ten years. First, should such taxes be used at all by the Federal Government? Legally the states have a prior claim, for the power to transmit property is theoretically conferred and controlled by them and not by the Federal Government. Whether the Federal Government should relinquish the taxes, however, must turn on pragmatic, not legalistic, conclusions. All would agree that if the United States is to employ these taxes, there should be much greater coördination with the states, at least administratively. It ought not to be beyond the wit of man to devise and to put into effect a single return form, duplicated for the two jurisdictions; a single administrative investigation; and even corresponding taxing provisions. At present, the United States certainly needs the money; these taxes are an appropriate measure of capacity to pay. Hence it is reasonable for the Federal Government to continue their use, always with an awareness of the state's employment of the same taxes, and with all possible efforts to simplify and unify administration. Thus the present credit against the federal estate tax for state death taxes should be continued, since it serves to

unify the two imposts and to lessen the burden imposed by them. It ought to be simplified, however, by gearing it to the present effective rates of the federal tax, not to the 1926 rates.

Somewhat more money could reasonably be obtained from both taxes. As in the case of the income tax, rates in the upper brackets are already very high. Hence the only effective course is to broaden the base by lowering exemptions, and to increase the lower part of the rate scale. There are now three distinct exemptions: (1) a $30,000 general gift-tax exemption, plus (2) $3,000 per year per donee; and (3) a $60,000 general estate-tax exemption. (The $40,000 insurance exemption was eliminated in 1942.) This situation is illustrative of one of the fundamental defects of the organization of these two taxes as two distinct and independent imposts, although they are really parts of a single whole —a system to collect taxes on the transfer of an individual's property by gift, whether during life or after death. An individual making a gift necessarily considers both taxes. As they stand now, very little integrated, they present needless legal complexities—needless, because integration of the two taxes would eliminate the complexities. What would be a proper program for integration?

a. The transfer tax should be single and cumulative on all donative transfers. The tax rates may properly be progressive, for, as in the case of the income tax, ability to pay increases more than proportionally as wealth grows. To give the principle real effect, account must be taken of total transfers by gift or bequest; that is, the tax should be cumulative, the bracket rates on any given transfer depending upon transfers previously made. In this way, a whole series of troublesome legal questions could be eliminated, such as, for example, whether a transfer was made in contemplation of death. There should be two sets of exemptions: (1) one

like the present $3,000 per year per person, to cover small recurrent gifts to needy persons or members of the family; and (2) a general over-all exemption, like the present $30,000 and $60,000 exemptions. Both of these might be reduced from the total of the present figures, in order to increase the revenue.

The great objection to this procedure will be the net increase in total estate and gift taxes which will probably follow, and the resulting diminution in the size of the estate that can be established as a reserve for one's dependents. This is a very real objection. The desire to protect one's home and one's family is fundamental, and within limits, the state should foster it, not defeat it by taxation. Two points may be made to support the proposal. In the first place, the change is largely mechanical and is designed to improve the operation of the two taxes. Congress adjusts the present taxes in the interests of fairness and the preservation of the economy; it would do the same thing with the proposed combined taxes. The next point is more fundamental.

b. No transfer taxes should apply to transfers between husband and wife. Whatever estate the spouses may have has been built up, to a greater or less degree, by joint effort and joint saving. If, as the Treasury has urged, the incomes of married persons should be taxed as a unit, because they represent a unitary capacity to pay, by the same token transfers within this taxing unit should not be taxed. This provision also would eliminate many of our present gift and estate tax problems, for it would encourage a return to earlier forms of simple transfers, instead of the present highly complicated trusts and powers. The Treasury would normally collect one transfer tax on each generation, which is enough. Finally, in facilitating part of the family security a husband normally wishes to provide, such a provision makes the reduction of the general exemptions the more feasible.

c. The rates of the new transfer tax should be graduated according to the value of property received and to the relationship of the recipient to the transferor. Granted that the state is to receive a tax upon donative transfers, either of two forms of taxation may be employed. The one, the inheritance tax, is generally used by the states; the other, the estate tax, by the Federal Government. Under the former, rates and exemptions are determined by the relationship of the recipient to the decedent, as well as by the size of the particular bequest. In an estate tax, the tax is measured by the value of all the decedent's property, irrespective of its recipients or the size of their bequests. As a matter of equity, should the tax be the same on a $25,000 gift or legacy, no matter by whom received, and should it be greater if the gift comes from a million-dollar estate than if it comes from a $100,000 one? Should the tax be the same whether the legacy is made to a stranger or to a daughter? Conclusions will differ; but in general the two questions—who gets the money and how much does he get—seem to be important factors in fixing the amount of tax. Certainly this is true if an unstated premise of the tax is a desire to break up large estates. But in any case, the receipt of the money or property by some living person who will enjoy it seems a more significant factor than the total size of the estate from which it sprang. Many more states have framed their death-tax laws on this basis than on the alternative estate-tax basis employed by the Federal Government.

This method of taxation would eliminate some difficult questions in the equitable taxation of property passing under powers of appointment or tied up in trusts. The touchstones in each instance would be merely our two questions above—who receives the interest in question, and how much is it worth? Thus it would make no difference whether the property passed under the exercise of a special power of

appointment or of a general power, or in default of the exercise of such a power; someone took the property, and it can be valued. The valuation problem is much more difficult in the case of an inheritance tax than in the case of an estate tax, since each interest transferred must be valued, and not simply the whole estate. But states have been solving these problems for years; they are not insuperable. If greater fairness is insured by the inheritance tax, an administration can live with it and apply it.

A transfer-tax structure along these lines would probably not be made to yield much more in the next few years than the present system, because (1) the exemption of transfers between spouses and (2) the somewhat lower taxes likely to be collected, as a result of the dispersion of estates among many takers, to each of whom the rates of tax are applied. There would be a marked increase in equity—in the assurance felt by the taxpayer that the state is not preventing him by taxation from providing adequately for his family.

SALES TAX

A sales tax by itself is not the best measure of tax-paying capacity, for purchases of goods do not increase proportionately with income. It is unlikely that a man with a $10,000 salary buys five times as much tobacco and liquor and groceries as a man with $2,000; and it is clear that a man with a $50,000 income does not buy 25 times as much. To express the same proposition another way, the proportion of income saved and not spent is apt to increase with the size of income. The limitation of the tax to sales of so-called luxuries is not of much use, for in this country automobiles, fur coats, and jewelry are pretty widely distributed among all classes of the population.

Notwithstanding these facts, the case for a general retail

sales tax today rests on solid grounds. The federal tax structure consists to a large extent—some 73 percent—of taxes measured by incomes, estates, and gifts. Viewed as a whole, the system is sufficiently geared to capacity to pay. In times like these, every citizen may properly be called on to pay some of the cost of our army, navy and federal establishment, for it serves all alike. Administratively the collection of an income tax from persons with small cash incomes, like some farmers and laborers, is difficult or impossible. It has been estimated that in 1941 the total net income of individuals was around $90 billions. Of this, $28–$31 billions was received by persons who filed no income-tax returns; $45–$48 billions by persons with less than $5,000 net income, who paid $700 millions income tax; and $14.6 billions by persons receiving over $5,000, who paid $2,800 millions of income taxes. Nearly 81 percent of the tax was paid by the latter group, who received about 16 percent of the income. The income tax did not reach at all, or touched lightly, a large segment of the national income. The increasing buying power which will cause undesired increases in living costs comes largely from this source. Although the 1942 law lowered exemptions and raised rates, it has not cured the situation. A general sales tax would be a real help in combating inflation.

The federal tax structure already employs many special sales taxes, notably those on tobacco, liquor, and gasoline. Many of these would be continued at higher than the general sales tax rate, some would be merged into it. The administrative problem of collecting a sales tax from many retailers would be serious but not impossible; as would the problem of correlating the tax with those of the states which now employ it. Although harder to collect, a retail sales tax is preferable to a manufacturer's tax, because there is less danger here of a pyramiding of the tax in the price to the

consumer. At a 5 percent rate, applied to all commodities save those already taxed more heavily, a sales tax might be expected to yield $2.5 billions to the Treasury. This is almost the only great source of revenue left untapped. The revenue is badly needed. The employment of a general sales tax would not prejudice the fairness of the tax structure as a whole, for it is now and would continue to be largely composed of taxes measured directly by incomes and estates. The adoption of a general sales tax is an important next step in the direction of more adequate federal taxation.

SPENDINGS TAX

Toward the end of the consideration of the revenue bill of 1942 by the Senate Finance Committee, the Treasury proposed a spendings tax with steeply progressive rates as an important additional revenue producer. The Committee rejected the proposal, moved in part perhaps by the fact that it came so late in the day, and could not be adequately analyzed. Subsequent statements by Treasury officials indicate that the tax will probably be proposed again in 1943.

The spendings tax was advocated many years ago as a substitute for the income tax. The tax is levied on what is spent, not on what is saved. Savings are a deduction from annual receipts for this purpose. Hence, the tax has several virtues: it encourages saving; it imposes a brake on spending (and with progressive rates, this brake can be made severe); it is applied only to income which is really enjoyed. In effect, the spendings tax is an income tax in a different form; with some additional administrative complications, since account must be taken of savings in various forms, as well as of receipts and deductions.

Much could be written on the relative desirability of a tax on net income as now defined, as compared to a tax on net income minus moneys saved. In general, the former

seems a better measure of taxable capacity, at least until rates become so high that savings are virtually impossible without some form of income-tax credit therefor. The kind of personal income tax to be included in a permanent federal tax system has already been discussed. The current proposal, however, has been to impose a spendings tax, with severely progressive rates, on top of the present income tax. So far as the tax system is concerned, there does not seem to be much point in adding the complexities of a new and different form of income tax to the already striking complexities of the present form. The addition of an income tax with a new name will not make any easier the payment of total income taxes due; rather, computations become more difficult. Credits for savings in various forms can be added quite as well to the present income tax, without the confusion of a new levy, alike in some respects and differing in others.

The spendings tax has been advocated mainly as an effective device to curb inflation. Although the details of the proposal were not made public in complete form in 1942, rates ranged from a normal 10 percent to a peak surtax of 75 percent at $10,000. The effective rate of the present income tax is over 21 percent at that level, and increases rapidly to over 50 percent at $50,000. Thus the spendings tax was designed to make impossible expenditures out of income of more than moderate amounts, which could not be greatly increased, no matter how much gross income increased. Whether expenditures could be increased by using capital was not wholly clear. The progression of the proposed rates was evidently formulated on the theory that the excess purchasing power which must be drained off is in the middle and upper brackets. That the bulk of the national income is received by persons in the lower middle and the lower brackets has already been shown. It seems

likely that with greatly increased employment in the war more income goes into the hands of persons with $5,000 or less; and hence that the increased buying power which must be diverted into savings, or absorbed by taxes, is in this enormous income group. If so, the spendings tax, as it was proposed, is not much better a device than the income tax for combatting inflation, for, like the income tax, it would have little effect upon the buying power of the mass of consumers. It was aimed at the wrong target. For reasons already stated, a retail sales tax seems to be better designed to meet present necessities.

SOCIAL SECURITY TAXES

These taxes, unlike the others discussed above, are earmarked as premiums to pay for designated benefits to employees: an old age annuity and unemployment insurance. For old age annuities, workers and employers each pay 1 percent on wages. Under the present law, this rate will advance to 2 percent each on January 1, 1944, to 3 percent each on January 1, 1949. For unemployment insurance, employers alone pay 3 percent of wage payments. The taxes apply to wage payments of $3,000 or less, but government employees, agricultural and domestic employees, and workers in educational, charitable, and religious organizations are exempt. Railroad employees have a special retirement act. Employees and railroads pay 3 percent each on wages up to $300 per month, in order to provide retirement annuities.

The Federal Government allows a credit up to 90 percent of its unemployment-insurance tax for taxes paid under approved state unemployment-insurance plans. Hence, the net yield of this tax to the Treasury is much less than that of the old-age insurance tax. In 1942, a total of $1,185,362,000 was collected in employment taxes, of which $895 millions was for old-age insurance, $120 millions for unemployment insurance, and $170 millions for railroad retirement annui-

ties. In general, moneys not required for current payments or for administration are deposited in trust funds in the Treasury, and invested in interest-bearing federal obligations. In fiscal 1942, the old-age and survivors trust fund was credited with deposits of $895.7 millions from taxes and $71 millions from interest; expenditures were $137 millions. The Unemployment Trust Fund, in which both the state and the railroad unemployment reserves are kept, received deposits of $1,243.6 millions, and expended $377.2 millions. The Railroad Retirement account expended $126.2 millions against $144.1 millions receipts. Thus deposits in all trust funds exceeded expenditures by $1,714 millions. The balances in the trust accounts are: old age, $3,227.2 millions; railroad retirement, $104.8 millions; and unemployment, $3,150.1 millions.

Recommendations to increase these taxes, particularly the old-age annuity tax, rest on at least two distinct grounds. It is urged that the benefits are not adequate, nor widely enough distributed. Additional contributions might be enforced now for these purposes. Again, the taxes are measured by wages, are currently collected, and are withheld at the source. They are therefore most effective in reducing current spending, for the worker never receives the tax money; and they are more readily collected from low income groups than an income tax could be. Thus they have the essential characteristics of tax equity, adequacy, and administrative simplicity; and they would help meet the inflation problem. Actually the two distinct bases for increases in these taxes are tied together: a proposal to increase the taxes would surely be accompanied by a demand to increase the benefits. However, the cost of increased benefits would be considerably deferred and the gain to the Treasury would be immediate. Should we then count on increased social-security taxes as a means of improving our revenue position?

The difficulty has already been shown: that if these taxes

are to be increased, benefits must be increased *pro tanto.* This means that the Federal Government must now commit itself to a particularized program of spending years hence that may not then appear to be well designed or wholly necessary. On the other hand, the imposition of an ordinary tax on gross income, to be withheld at the source, would not tie the government's hands in the future, for the government would not then be committed to any program of repayments to the taxpayers. On the whole, it seems wise to follow the latter course—to use methods of raising money today which do not involve commitments of the expenditure tomorrow of a similar amount for designated purposes. What social security should be provided in the way of unemployment insurance or old-age annuities should be decided by the social scientist, not the tax specialist. If greater benefits are necessary or desirable, taxes should be increased to compensate for them; but the guiding principle should be, not the need for present revenue, but the social desirability of increasing the class of insured persons or of broadening the scope of annuities to be paid.

Finally, in this instance as in others, we need to be concerned at all times with the question of how much social security our economic structure can afford.

Conclusion

Most of the discussion in this chapter has been addressed to the composition of a federal tax system after the war. Needless to say, the formulation of a program for a period distant by an uncertain number of years, for a country that will have been racked by strains we cannot yet fully comprehend, for a government whose obligations, financial and social, whose role and indeed whose form of organization must be guessed at, is a highly speculative enterprise. It is truly an act of faith that society, and government, and tax philosophy will rest upon principles discernible today. A

more prudent and less optimistic student of taxation would conclude to withhold any statement of aims until he can be surer of the environment in which his revenue program is to operate. On the other hand, the very facts that the outlook is uncertain and the times confused are good reasons for the attempt to state some standards. Even though the future does not actually work out as we now think it may, it is worth while to consider now what we face as citizens; to decide what sort of a tax system we would like to have; and to take what steps we can toward the accomplishment of our purposes.

Since the principles and philosophy of a good tax system must necessarily be stated in broad general terms, persons who agree with the principles may differ considerably in their precise application. Just what the rates and exemptions of the income tax should be, and how much revenue should be raised by an estate tax will be decided differently by the Ways and Means Committee, a Treasury official, and an economist, though all three are in possession of the same data. The following table and comments represent my formulation of the major sources of tax revenue of the Federal Government, after the war, assuming that about $20 billions must be raised.

Taxes	*Annual Revenue in Billions of Dollars*
1. Income, individual	8.
2. Income, corporation	4.4
3. Estate and gift	1.
4. Liquor	1.5
5. Tobacco	1.
6. Miscellaneous excises	1.5
7. General sales	2.6
Total	20.
8. Social security	1.2–2.4[6]

[6] Dependent upon the effective rates.

1. The total revenue is approximately that produced under the 1942 law. The adjustments suggested in the text would alter the rate structure, chiefly by increasing the normal tax.

2. The excess-profits tax is eliminated. Corporation income-tax rates are maintained at approximately the levels set by the 1942 law, but a credit will be granted to stockholders for dividends received from taxable corporations.

3. The estate tax and gift tax will be integrated as a general cumulative tax upon transfers by gift or bequest. Rates on transfers outside the immediate family will be higher than present rates.

4, 5. A continuation of substantially the 1942 rates and provisions is contemplated.

6, 7. The principal excises are gasoline, motor-vehicle, and admissions taxes. A general sales tax would be levied at 5 percent, excluding sales of articles taxed at higher rates.

During the fiscal year 1943, and during the continuance of the war, the Federal Government will spend greatly more than it can raise by taxes. The figures are roughly $26 billions raised in taxes under present laws in a full year of operation against $80 billions to be expended. Experts generally agree that we should tax ourselves more heavily, not only to pay a greater share of war costs as we go, not only to reduce *pro tanto* the serious financing problem the Treasury faces, but to sop up more of the spending power of a greatly increased national income that will otherwise bid up the prices on a decreased stock of civilian goods. A reasonable judgment would be that we should try to raise at least $35 billions in taxes per year, still less than half what we shall spend. Moreover, the tax bill to raise the $10 billions additional should be passed as quickly as possible in 1943, and should not be delayed and debated for months, as in 1942.

If a completely unprecedented total of this magnitude is

to be collected, it is evident that many of the desirable modifications of the system in the interests of the taxpayer cannot now be made. For example, corporation taxes cannot be much reduced; the excess-profits tax cannot be repealed or much alleviated; individuals cannot be given a full credit for corporate taxes paid on the dividends they receive. Necessity compels the erection of the new revenue structure on top of the existing system, in the main unchanged. Betterments in the present structure for the most part will have to be left until after the war.

How raise $10 billions more? The program in general outline would be: $5 billions from a 10 percent general retail sales tax; $1 billion from tightening up the excess profits tax; $4 billions from the personal income tax, to be obtained mainly by lowering exemptions further, and severely increasing the normal tax rate. Perhaps $500 millions more can be obtained from the estate tax and the gift tax; if so, the income tax increases can be made that much less drastic. This is certainly not an attractive program, for it means, among other things, a decided decrease in living standards for many of us. Nevertheless, a dispassionate examination of the facts indicates that it is a minimum program for national financial health.

The purpose of this chapter is mainly to provide a background for the discussion to come. If, as seems inevitable, taxes will be very much higher throughout the next decade than they have been in the decade just past, then the incidental effects of taxation on family settlements and on business transactions will be more pronounced. It is worth while to discover what these effects are, in order that appraisal of the fiscal system may not be focused too intensely on the revenue it produces.

CHAPTER II

THE INCOME TAX ON THE FAMILY

CONGRESS and the Supreme Court have developed the legal concept of income largely out of the infinite factual variations of two typical situations: dispositions of property or income within a family, and dispositions of property or income by a corporation to its shareholders.[1] In each situation both governmental agencies have participated actively, the legislature prescribing a few general rules, the judiciary applying them and frequently going well beyond them to state new general rules of its own. Congress is always aware of considerations of policy aside from revenue yield; but in recent years, yield has been so important that the talk has been mainly of two items of policy of chief concern to the Treasury: the elimination of tax avoidance or loopholes or special privileges; and ease of administration. The Supreme Court, particularly in recent years, has also indicated its awareness of policy considerations; but, partly because of inherent restrictions on the scope of its operations to the construction of an existing set of words in a statute, the Court's main concern has seemed to be with the same two items of policy. There is good reason, therefore, in this unofficial volume, to direct attention to other policy considera-

[1] This chapter is a revision and amplification of articles which have appeared in (1941) 20 TEXAS L. REV. 150 *(The Federal Income Tax on the Family)* and (1941) 72 JOURNAL OF ACCOUNTANCY 487 *(The Supreme Court on Federal Taxation 1940–41)*. Reproduced by permission of the publishers.

tions primarily important to the citizens. Since federal taxes are almost the main single force in determining the form that family and business arrangements for the disposition of property shall take, in what directions are the present statutes and decisions driving us? What are sanctioned settlements, what settlements are discouraged?

To answer these questions involves a study of the three major taxes affecting family arrangements, the income tax, gift tax, and estate tax. The approach will necessarily be legal, since we must start with the statute and the decisions. The policy questions are not legal at all. The layman as well as the economist can determine almost as well as the lawyer what is good for the family or for the community. The lawyer ought to have a somewhat better acquaintance with the materials, as well as with the practical operations of tax laws in particular cases. The scheme of this chapter and Chapter 3 is to outline the principal points of impact of the federal revenue laws upon family arrangements, and to consider the desirability of the present legal conclusions, legislative or judicial. "Desirability" will be determined from the point of view of a lawyer. Is the rule workable? How does it fit into the general structure of the tax laws and interpretations? To what result does it lead?

Returns

The proposal of the House Ways and Means Committee that the incomes of husbands and wives living together shall be included in a single joint return[2] aroused vociferous comment and criticism—criticism which direct increases in surtax rates failed to arouse. Discussion has centered, however,

[2] H. R. 5417, 77th Cong., 1st Sess. (Sept. 20, 1941) § 111, as reported to the House. The provisions for compulsory joint returns were eliminated in the House. The Senate Finance Committee proposed that community income be taxable to the earner and the spouse having the management and control of the property producing the income (§ 119), but this provision was eliminated in the Senate.

not on the legal or constitutional aspects of the proposal, but on its moral and social aspects. There is room, therefore, for an analysis of two major legal questions.[3] First, to what extent is the taxation of husband and wife on a joint return a simple and a "natural" arrangement, which will enable the elimination of more complicated provisions designed to block the husband from freeing himself from tax on income, if he enjoys control of it? Second, is the requirement of a joint return for husbands and wives living together apt to be upheld by the Supreme Court?

Husbands and wives have previously been permitted, under the federal law, to file a joint return or separate returns at their option.[4] The theories back of the respective alternatives were, of course, different. On the one hand, the owner of an income, even though a spouse, can generally insist on its being taxed separately as his own,[5] with qualifications in particular cases of assigned income and trust income, to be discussed below. The married-women's property acts have moved in the direction of increasing recognition of the distinct and separate individuality of the wife as a person and property owner. On the other hand, two harmonious spouses with separate incomes can be regarded as a taxable unit, certainly if they so elect, since the combined incomes may be used no differently than would be a like

[3] Irrespective of the defeat of the joint-return proposal, these questions are worth consideration, for the proposal is a perennial one. Secretary Morgenthau advanced it in 1933 [*Statement Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means* (1933) 14, 15].

[4] Int. Rev. Code § 51; U. S. Treas. Reg. 103, § 19.51–1. The option can be exercised each year; spouses are not concluded by past elections.

[5] Hoeper v. Wisconsin, 284 U. S. 206, 215 (1931) in which a provision of the Wisconsin state income-tax law, requiring a husband to include his wife's income in his return, was held invalid. "Any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income."

amount owned by the husband or wife alone. Naturally, the option to file separate or joint returns will be so exercised as to produce the least total tax. If each spouse has a substantial income, there is a saving in separate returns; if one has an excess of allowable deductions over his gross income, it is often profitable to file a single return, so that the deductions can be charged against the income of the other spouse.

Transfers of Assets

Moreover, spouses could often bring about a tax saving by a division of assets or income between them, through some valid legal mode of transfer. Since the surtax rates are steeply progressive, a family whose aggregate income is divided among several individuals or trusts may very well pay less total income taxes than one whose assets and income are concentrated in the hands of the husband and father.[6] The split may be accomplished in various ways, as by the assignment of income or the gift of income-producing assets to a wife or child, or to a trust for their benefit. Subject to possible qualifications which may be in course of establishment by recent decisions,[7] an outright gift of income-producing assets has been effective to transfer the income therefrom into the donee's ownership and thus into his tax return. If the donee owns the assets, ordinarily he must report the income. The donor may come under a liability for a gift tax, if the gift is large enough, but even so there may be a net tax saving of importance. If appreciated assets are transferred to a wife or children, a gift tax is payable on the then value of the asset; further, the donee must use the donor's basis on a sale;[8] but the total taxes may well be less than had

[6] See MONTGOMERY, FEDERAL TAX HANDBOOK (1940–41) 2061 *et seq.*

[7] See the discussion of the *Horst* and *Clifford* decisions, *infra* pp. 52, 58.

[8] INT. REV. CODE § 113(a) (2). But if the value of donated property is less than cost to the donor, the basis is the value, not the cost.

the donor sold the assets, because of the lower income-tax brackets of the donees.[9]

A variation is a sale of assets by one spouse to the other. Under Section 24(h) of the Code,[10] losses on such sales are disallowed [as are losses on sales between other members of the family, as defined in Section 24 (b)(2)(D)];[11] and no doubt the terms and *bona fides* of such sales are open to scrutiny.[12]

Thus the income tax law has broadly encouraged gifts of income-producing property by one spouse to the other, or by a parent to adult children.[13] The gift tax and estate tax have operated in the same direction, since the gift-tax rates are materially less than the estate-tax rates and a separate set of exemptions are granted.[14] The adoption of provisions for compulsory joint-income tax returns would seriously discourage gifts of property between spouses, though not from parents to adult children. Indeed if the incomes of spouses are to be taxed as a unit, a logical corollary would be to ignore transfers between spouses for gift and estate purposes. The Treasury has not carried its proposal to this logical end, nor has Congress, probably for revenue reasons. Yet it is pretty clearly unfair to treat spouses as a unit in taxing their respective incomes, but as distinct persons in taxing a transfer of property from one to the other.

[9] See *Hearings of Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 4, 262 *et seq.*; Paul, *The Background of the Revenue Act of 1937* (1937) 5 U. of Chi. L. Rev. 41, 71.

[10] Throughout the book, the term "Code" refers to the Internal Revenue Code of 1939, as since amended.

[11] "The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

[12] See United States Treas. Reg. 79, Art. 8, on the gift tax; *cf.* McLean v. Commissioner of Int. Rev., 41 B. T. A. 565 (1940), *aff'd*, 120 F. (2d) 942 (C. C. A. 5th, 1941), *cert. denied*, 314 U. S. 670 (1941), *petition for rehearing denied*, 314 U. S. 710 (1941).

[13] Adult children, because to a considerable degree the income of property owned by minors seems to be taxable to the father. See p. 66 *infra*.

[14] See Chapter III, *infra*.

Residence in a community-property state[15] has effected a similar result of dividing income between spouses, since under the local law husband and wife each have present vested interests in one-half of the community income, whether or not all the income is earned by one spouse, and since the prior federal law has in this respect given effect to the local law.[16] Although community-property laws vary in theory and operation[17] it is at least arguable that a lawyer in Dallas or San Francisco, who is married and living with his wife, has quite as much actual control over and enjoyment of his income as a lawyer with like earnings in Chicago or New York. Yet his federal income tax is very much less.[18] Hence there has been a drive for years to compel the owner of income in a community-property state to pay the tax upon all of it, as do owners of income in other parts of the country. The proposal of compulsory joint returns is based in large part on a similar desire to impose a like tax on incomes of like size, whether earned in community-property states or elsewhere. The latter proposal, however, operates to penalize spouses in all states in order to get at spouses in the nine states.

Assigned Income

Nearly twenty years ago, Congress, stimulated by the Treasury, took the first steps toward establishing the proposition that income which an individual controls is taxable to him, even if he does not receive it. Specifically, the income

[15] Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Oklahoma passed a statute in 1939, permitting spouses to elect to treat their property as community property. OKLA. STAT. ANN. (Supp. 1940) Div. 12, § 1665a.

[16] See Poe v. Seaborn, 282 U. S. 101 (1930); as to Texas, Hopkins v. Bacon, 282 U. S. 122 (1930). The constitutionality of a federal statutory change in this scheme of things is discussed below, p. 72.

[17] See Oliver, *Community Property and the Taxation of Family Income* (1942) 20 TEXAS L. REV. 532; Ray, *Proposed Changes in Federal Taxation of Community Property* (1942) 30 CALIF. L. REV. 397.

[18] If his net income is $10,000, he saves around $350 by living in California or Texas; if $25,000, more than $2,600.

of a revocable trust was made taxable to the settlor.[19] Although Congress later elaborated this subdivision, it did not enact additional provisions applicable to other forms of "controlled" income, such as assigned income, income in community-property states,[20] and the income of short-term trusts.[21] The Supreme Court took up the burden, however, and in the course of the years has largely eliminated the necessity for legislation, except in the community-property field.

If spouses divide assets among themselves by gift or sale, the income is generally reportable by the owner of the asset. An assignment of income to be earned or accrued in the future has been held ineffective, however, to take the income out of the return of the assignor, not by virtue of any specific provision of the statute, but by implication from its general definitions and plan. In *Lucas v. Earl*[22] a husband and wife contracted in 1901, long before the federal income-tax amendment was adopted, that all their property and earnings should be received and owned by them as joint tenants. In question were the husband's attorney's fees for 1920 and 1921. The court held, without a dissent,

[19] This statement is still overgeneralized. The actual provision, as originally adopted in § 219(g) of the Rev. Act of 1924, read: "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Similar provisions, broadened and perfected, appear in Section 166 of the INT. REV. CODE. See MAGILL, TAXABLE INCOME (1936) 274 *et seq.*, for a discussion of history and scope.

[20] The Treasury has frequently recommended that, in the community-property states, the one who earned or controlled the income be required to report it, but without important results until 1941, when the Senate Finance Committee adopted the recommendation. It was eliminated from the bill on the Senate floor.

[21] The Treasury made a recommendation in 1933 for legislation to cover this subject, but none was adopted.

[22] 281 U. S. 111 (1930).

that the fees were entirely taxable to the husband. Mr. Justice Holmes said:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

So also in *Burnet v. Leininger*[23] an assignment of a share in future partnership earnings, the assignee not becoming a partner,[24] however, was ineffective to relieve the assignor from income tax on his full portion of the earnings. The court emphasized (1) that the assignee's interest was purely derivative; the income must be earned by the assignor before it could become the property of the assignee; (2) that the statute requires the partner to report his distributive share.[25] This latter argument is much better grounded here than in the *Earl* case, since the statute does specifically provide how partners are to be taxed;[26] whereas in the *Earl* case Mr. Justice Holmes had to rely upon the section—now Section 22(a)—defining gross income in general terms. In both cases, however, the results are sound; salary or partnership earnings should fairly be taxed to the person whose services produced them,[27] and who therefore directly controls the flow of income.

The question remained, however, whether the doctrine

[23] 285 U. S. 136 (1932).

[24] *Cf.* Humphreys v. Commissioner of Int. Rev., 88 F. (2d) 430 (C. C. A. 2d, 1937), where two attorneys successfully introduced their wives into the partnership, the wives contributing capital but no services.

[25] See INT. REV. CODE § 182 (1939).

[26] INT. REV. CODE § 181 *et seq.* (1939).

[27] A fuller discussion appears in MAGILL, TAXABLE INCOME (1936) 250 *et seq.*

of *Lucas v. Earl* applied only to income to be earned by or produced under the direction of the assignor in the future. The court had held that if a life beneficiary of a trust validly assigned part of his interest in income, the assignee was thereafter taxable on his receipts.[28] The court had denied certiorari in a case[29] in which the assignee had been held taxable on assigned renewal commissions on insurance, already earned by the assignor. One lower court had held the assignee taxable on interest coupons clipped from bonds and validly transferred to him.[30] Both situations came before the court in 1940. In both, the assignor was held taxable.[31]

Mr. Horst had transferred to his adult son on August 10, 1934, $25,182.50 face-value coupons cut from bonds. Later in the year, how much later does not appear, the donee collected this amount, and reported it as his own income. In August, 1935, Mr. Horst transferred to his son $37,032.50 face-value coupons, from which the son realized $25,495 later in that year. The son reported as income the amounts collected, and the father did not. The Commissioner determined deficiencies against the father, on $25,182.50 of omitted income for 1934 "as the value of the coupons transferred to Robert P. K. Horst in that year"; and on $22,360 of omitted income for 1935 "as the aggregate net worth of all the coupons transferred by the petitioner to his son in that year."[32] The Board sustained the Commissioner, concluding that the donor realized income "in the full amounts collected from the coupons"; and noting that the Commis-

[28] Blair v. Commissioner, 300 U. S. 5 (1937).

[29] Hall v. Burnet, 54 F. (2d) 443 (App. D. C. 1931), *cert. denied,* 285 U. S. 552 (1932).

[30] Rosenwald v. Commissioner, 33 F. (2d) 423 (C. C. A. 7th, 1929), *cert. denied,* 280 U. S. 599 (1929).

[31] Helvering v. Horst, 311 U. S. 112 (1940); Helvering v. Eubank, 311 U. S. 122 (1940).

[32] Findings of fact in Horst v. Commissioner, 39 B. T. A. 757 at 758–59 (1939).

sioner had not determined a deficiency in the full possible amount for 1935. The Circuit Court of Appeals for the Second Circuit reversed,[33] and on certiorari, the Supreme Court reversed the Circuit Court.

The Circuit Court had thought the case distinguishable from such cases as *Lucas v. Earl*[34] and *Burnet v. Leininger*,[35] in which the income assigned was the product of work to be performed by the assignor. In such a case, the assignor has a direct control over the income to be received by the assignee; hence the income may properly be regarded as the assignor's. In the *Horst* case, the assignee obtained enforceable obligations, freed from any control by the assignor. Moreover, since the donee was an adult, the donor was under no duty to support him. How, then, did the donor realize income, in the absence of any cash receipt, control, or the discharge of a pecuniary obligation? Mr. Justice Stone expressed his philosophy thus:[36]

> Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money, he derives money's worth from the disposition of the coupons which he has used as money or money's

[33] 107 F. (2d) 906 (1939).

[34] Cited *supra,* note 22.

[35] 285 U. S. 136 (1932); (1932) 32 COLUMBIA LAW REV. 1080; (1932) 41 YALE L. J. 925—husband, partner in a laundry, who made his wife "partner" with him in profits and losses (but she did not become a partner in the laundry), *held* taxable on his full share of the laundry's earnings.

[36] 311 U. S. 112 (1940) at 117.

worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth.

In the companion *Eubank* case[37] the majority of the Court arrived at a similar conclusion with respect to the taxation of renewal commissions, due to the assignor on business previously written, and assigned by him in 1924 and 1928 to a corporate trustee. Three justices dissented in each case, on the ground that complete ownership and control of the income had passed to the assignee.

There is no specific legislative sanction for either holding. The Court necessarily developed its own concept of income. Had the control test been rigidly applied, the result might have been to treat the income as taxable to the assignee, as the three dissenting justices concluded. The majority was no doubt moved in part by a desire to forestall tax avoidance. Assignments of bond coupons separated from the bond or assignments of insurance commissions are not common commercial transactions. Their usual motive is, no doubt, a desire on the part of the assignor to provide a relative with an income on which the assignor would not have to pay the tax. Moreover, to each case the metaphor of the *Earl* case is largely applicable; the assignor owned the tree on which the fruit grew, and in the bond-coupon case, still owns it. To hold the assignor taxable under the circumstances does not offend one's sense of fair play.

At first blush, the definition of income invoked in the two cases goes well beyond previous limits and, moreover, lacks precise outlines. Nearly all donative transfers of property give the donor satisfaction, else he would not make them. Is the income of any trust therefore taxable to the settlor? Or only the income of trusts for members of his immediate family? Or is the decision limited to transfers of income, not of property producing income? Finally, what of the gift tax in

[37] Helvering v. Eubank, 311 U. S. 122 (1940).

these situations? Is there not necessarily an inconsistency in treating the assignor for gift-tax purposes as having made an out-and-out transfer of valuable property interests and at the same time treating him as the owner of the income for income-tax purposes?

The method of treatment which the Commissioner evidently employed as to the 1935 coupons in the *Horst* case (and which the Board disapproved) offers a clue to another possible interpretation and application of the decision. The amount of income which the settlor controlled, and the value of his gift, was the present worth of the coupons at the time of their transfer to the donee.[38] To this extent the income had, in a broad sense, accrued to him before the transfer. After the transfer, the donee might sell the coupons to someone else or give them away. The increase in the value of the coupons after the gift should not be regarded as income to the donor, for he does not receive or control it, it does not accrue in any sense in his hands, and it may not even be received by the donee. This interpretation—that the income taxable to the donor is the discounted value of the coupons given—has various technical advantages. It does not broaden the definition of income to an indefinite extent to include purely intangible "satisfactions." The theory of accrual involved is not dissimilar to that invoked by Section 42, in the case of the death of the income recipient,[39] or by Section 44(d), in the case of transfer of installment obligations. It brings about consistency between the gift tax and the income tax. Clearly the donor made a taxable gift in the present value of the coupons. It is not inconsistent to treat

[38] Thus, if I give my wife on January 15 a coupon calling for the payment of $50 on July 1, I have made a taxable gift to the extent of the January 15th value of the coupon, say $49. Note that even if the coupon were given before the period in which it accrues (gift in April, 1942, of coupon falling due on July 1, 1944) it would still have an ascertainable discounted value.

[39] This section is discussed p. 171 *infra*.

him also as having had that much income accrue in his hands. Finally, this interpretation would not require a settlor to be taxed on his wife's life income from an irrevocable trust,[40] or on the full amount of income from securities which he had given her.

The *Eubank* decision must be sustained on different grounds. Here the assignor, unlike Mr. Horst, did not retain the income-producing asset; he parted with all he had. The renewal commissions can hardly be regarded as accruing before the years in which they fall due, and hence in the taxable year do not to any degree accrue to the assignor, who had fully parted with the right to them years before. The case evidently stands for the proposition that whatever income Eubank may earn is taxable to him when it is paid, even though he has irrevocably assigned it before payment. The tax on earnings cannot be avoided by assignment, whether before or after the work has been performed.

In the subsequently decided case of *Harrison v. Schaffner,*[41] the Court held that assignments of dollar amounts to her children by a life beneficiary of a trust out of her trust income for the year did not reduce the amount of income taxable to the life beneficiary. The *Horst* and *Clifford*[42] decisions together fully support this conclusion. There is still the possibility, however, that some fragment, at least, of the *Blair* decision[43] remains good law: that if the life beneficiary

[40] Thus, in Commissioner v. Chamberlain, 121 F. (2d) 765 (C. C. A. 2d, 1941) the Court, in holding a settlor *not* taxable on the income of a four year trust for the benefit of the Legislative Drafting Fund of Columbia University, said in part: "We cannot believe the *Horst* case means that every settlor of a trust is taxable upon whatever part of its income is applied to purposes, the furthering of which gives him some satisfaction."

[41] 312 U. S. 579 (1941).

[42] Helvering v. Clifford, 309 U. S. 331 (1940), (1940) 53 Harv. L. Rev. 1050, discussed *infra,* p. 58.

[43] Blair v. Commissioner, 300 U. S. 5 (1937). A beneficiary of a trust entitled to income irrevocably assigned a part to another. *Held:* assignor is not subsequently taxable upon distributions of income to the assignee under the assignment.

assigns, say to an adult child, one half of the trust income during his life, the assignee and not the assignor will be taxable thereon. The three "control" factors mentioned in the *Clifford* opinion—the short term of the trust, the retention of the income in the immediate family, and control by the settlor as trustee—are doubtless complementary, as the Circuit Court of Appeals for the Second Circuit has recently held.[44] Even though the term of the trust is somewhat more than five years, or the trustee is a family friend, the income may still be taxable to the settlor if it is kept in the immediate family. As practical men, not lawyers, would view it, the position evidently is that if the donor has retained substantial control over the income or over its source during the period it accrued, the income is taxable to him.

Thus, a gift may result in income not to the donee, but to the donor. Some economists have regarded a gift as income to the donee,[45] but apparently never to the donor.[46] The doctrine of *Taft v. Bowers*[47] is given a new twist. The *Horst* decision, on one interpretation outlined here, affords a possible basis for taxing to a husband his wife's income from securities that he has given her, to the extent that the coupons had a value when he made the gift. On the broader interpretation—that one realizes income from the satisfaction of seeing a donee of one's choice receive payments of income—a much longer list of gifts, notably gifts in trust, may be treated as taxable to the donor.

[44] Helvering v. Elias, 122 F. (2d) 171 (C. C. A. 2d, 1941), *cert. denied,* 314 U. S. 692 (1941).

[45] See HAIG, THE FEDERAL INCOME TAX (1921) 27.

[46] As suggested above, however, it is probably not the "gift" which the Court regards as income to the donor, but the value which can be thought to have accrued in his hands.

[47] 278 U. S. 470 (1929). That case upheld the validity of the provision requiring the donee to use the donor's basis in computing gain from a sale of donated property. The court reasoned that a tax on gain accumulated in the donor's hands was due to the government, and Congress could fairly require the donee to pay it after a sale. In the *Horst* case, the Court compels the donor to pay the tax on interest income "accrued" in the *donor's* hands.

Short-Term Trusts

In the trusts field, Congress and the Court have long been confronted with three underlying propositions. (1) By the use of trusts, a man of property can divide income otherwise taxable to him at progressive rates among beneficiaries who may be members of his immediate family, and whom he would normally provide with similar amounts for living expenses. (2) Thus the rigors of the tax can largely be abated by some wealthier taxpayers, with resultant unequal application of the tax to similar situations, as well as loss of revenue. (3) The Congress has covered some but not all of the possible situations with explicit statutory provisions. Alimony trusts have been specifically provided for, but not short-term trusts, though the Treasury seven years ago asked for a statutory amendment applicable to them.[48] In situations not explicitly covered, is the income of the particular trust taxable under the general rule to the beneficiary who receives it? or should the Court attempt to do in some cases what Congress failed to do—seek to obviate avoidance by holding the income taxable to the settlor by a judicially enacted exception to the general rule?

Helvering v. Clifford[49] (in which the Court held that the income of a short-term trust is taxable to the husband-settlor) was an extension of the income-tax statute by the Court, but on the whole a desirable one. On the basis of statutory history and the usual rules of statutory construction, a contrary result could more easily have been reached, as Mr. Justice Roberts showed in a dissent. The more diffi-

[48] Statement of the Acting Secretary of the Treasury, p. 18, par. (6) (1933).

[49] 309 U. S. 331 (1940), noted in (1940) 53 Harv. L. Rev. 1050. *Cf.* Helvering v. Wood, 309 U. S. 344 (1940), holding that § 166 of the 1934 Act does not make the income of short-term trust taxable to the settlor. See Rudick, *The Problem of Personal Income Tax Avoidance* (1940) 7 Law & Contemp. Prob. 243, 258; *Irrevocable Trusts and the Federal Income Tax* (1940) 49 Yale L. J. 1305.

cult problem, however, is the scope of the holding—a matter that will now have to be pieced out through many lower court and then a few Supreme Court decisions.

In the *Clifford* case the husband declared himself trustee of certain securities for the benefit of his wife for a term of five years, subject to prior termination at the death of either spouse. During the term of the trust, the husband was to pay the wife such portions of the income as he might determine; at its termination, she was to receive any accrued income, but he was to have back the corpus. He retained extensive powers of management. The husband paid a gift tax at the time the trust was created. The Supreme Court held that the income was all taxable to the husband under Section 22 (a) of the Internal Revenue Code, defining gross income in broad terms. In the companion case of *Helvering v. Wood*[50] it was held that Section 166, dealing with revocable trusts, was not broad enough to accomplish that result. In both cases, it was brought out that the Treasury had recommended in 1934 that Section 166 be extended to the income of short-term trusts, but Congress did not act. Hence, the petitioners argued in each of the two cases that this statutory history showed that the law in terms does not provide for taxing to the husband this income received by his wife. Mr. Justice Roberts adopted this point of view, concurred in by Mr. Justice McReynolds.

The Treasury was shrewd in bringing the *Clifford* case to the Court as its first essay in the short-term trust field, for all its factual aspects are as favorable as possible to the contention that the income should be taxable to the husband. The result reached is a fair one, though the purist would certainly prefer to see it reached by statute rather than by decision. But what is to happen when the facts are changed? What is a short-term trust? Certainly one of five years or

[50] 309 U. S. 344 (1940).

three years,[51] probably not one of ten years. Suppose the trustee is a trust company, the beneficiary not a relative. What is there in the particular taxable year which can be regarded as income to the settlor? His control over the income in that year may be nil, although he has not relinquished his complete ownership for very long. He benefits only by the intangible satisfaction of seeing the income paid as he directed; but this satisfaction may not be at all equivalent to the discharge of a "pressing social duty," found by the court in *Burnet v. Wells*.[52] It seems the income should then be taxed to the recipient, not the settlor. Mr. Justice Douglas may have epitomized the basis of the *Clifford* decision in the sentence: "Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position."[53] Thus it is benefit to, plus control by, the settlor which makes the income taxable to the settlor. In the supposed case, neither of these reasons would apply with like force.

Again, we have believed hitherto that trust income was not necessarily taxable to a settlor, merely because he made himself trustee.[54] There is, however, much in the *Clifford* decision regarding control: "The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the 'victim of despotic power when for the purpose of taxation he is treated as owner altogether.'"[55] To summarize, the basic factors causing the income to be taxed to the settlor seem to be: (1) the short term of the trust; (2) the settlor's high degree of control; and (3) the

[51] The lengths of the two trusts involved in the *Clifford* and *Wood* cases.

[52] 289 U. S. 670 (1933).

[53] 309 U. S. 331, 335–36 (1940).

[54] *Cf.* Reinecke v. Northern Trust Co., 278 U. S. 339 (1929), as to the estate tax; Canfield v. Commissioner, 31 B. T. A. 724 (1934), as to the income tax.

[55] 309 U. S. 331, 337 (1940).

fact that the income stayed in the family. Certainly one cannot be sure that the elimination of any one of these would change the result, but it would surely reduce the likelihood of a similar decision.

The most sensible interpretation would seem to be that the three designated factors—the term of the trust, control by the settlor, and the beneficiary—are complementary. Income of a trust for a somewhat longer term than five years may be taxable to the settlor if his degree of control is high,[56] or the income of a three-year trust may be taxable to the settlor, though the beneficiary is not a member of his immediate family.[57]

The income of a four-year trust created with a trust company to send a young friend of the settlor's through college should not, it seems to me, be taxable to the settlor; but if the beneficiary is the settlor's son, it probably would be, even though he had reached his majority. Nevertheless these conclusions cannot be relied upon too certainly. If the "benefit" which is taxable as income can be whittled down to the intangible "satisfaction" that appeared in the *Horst* case, may not "control" be reduced to the actual supervision of the trust corpus or actual power to influence the trustee, plus payment to a beneficiary of the settlor's choice?

[56] See Helvering v. Elias, 122 F. (2d) 171 (C. C. A. 2d, 1941), *cert. denied,* 314 U. S. 692 (1941). Settlor reserved power to revoke in 1936, 6½ years after creation of trust; trustee was her husband; beneficiaries their children. *Held,* Settlor taxable on income in 1934 and 1935.

In *Commissioner of Int. Rev. v. Buck,* 120 F. (2d) 775 (C. C. A. 2d, 1941), the trust was for lives, and the trustee a bank, but the beneficiaries were the settlor's wife and children; and he reserved full power to reallot the income except to himself. The Court held the settlor taxable on the income, because of his complete control.

[57] *Cf.,* however, the *Chamberlain* decision in note 40 *supra;* Commissioner v. Barbour 122 F. (2d) 165 (C. C. A. 2, 1941), *cert. denied,* 314 U. S. 691 (1941) and Commissioner v. Woolley 122 F. (2d) 167 (C. C. A. 2d, 1941), *cert. denied,* 314 U. S. 693 (1941).

Revocable Trusts

Had the *Clifford* and *Horst* cases been decided twenty years ago, the provisions of sections 166 and 167 might have been quite unnecessary. In 1924, however, when the forerunners of these sections were first introduced into the law, it was not clear even that the income of a revocable trust was taxable to the settlor;[58] nor the income of a trust to pay premiums on his life insurance. The sections were therefore adopted, elaborated during the years, and gradually encrusted with judicial expositions. Then a few years ago, it occurred to some ingenious government advocate that the sections, though detailed and precise, were not necessarily exclusive even in their own field—and the *Clifford* decision proved him right. The result of that decision, and later of the *Horst* decision, is that in the case of any trust there are two lines of inquiry: Is its income taxable to the settlor under the terms of Section 166 or 167? Even if not, should its income be regarded as the settlor's under the reasoning and definitions of income contained in those two cases? It is harder to come to definite conclusions on the second inquiry than on the first.

The original provision treating the income from a revocable trust as taxable to the settlor was upheld in *Corliss v. Bowers*.[59] Mr. Justice Holmes said, for the Court: "Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." This is, of course, a statement of the "control" test. There can be little quarrel with the decision today, certainly as applied to the simple case of an absolute power to revoke at any time.

[58] The Treasury had ruled that the settlor was taxable on such income (U. S. Treas. Reg. 33, Art. 29; U. S. Treas. Reg. 45, Art. 341), but in 1922 this position was reversed. L. O. 1102, 1–2 Cum. Bull. 50 (1922).

[59] 281 U. S. 376 (1930).

The statute as originally drawn[60] was defective in providing that "where the grantor of a trust has, *at any time during the taxable year* . . . the power to revest in himself title to any part of the corpus" the trust income should be included in his return. Suppose the trust was revocable only if notice was given a year in advance? Today we should expect the Court to reason that the phrase "during the taxable year" modifies "power"—that if the grantor has the power this year to revest title in himself sometime in the future, the income is taxable to him. The lower courts, however, adopted the contrary interpretation: the income was taxable to the settlor in a given year only if he was able in that year to revest title in himself *for* that year.[61] In 1934, therefore, the phrase "during the taxable year" was eliminated. Since then, many questions have arisen as to trusts containing powers of revocation subject to other contingencies, such as the death of a particular beneficiary. The degree of control by the settlor in fact seems then to be determinative. Now that we know that the income of a short-term irrevocable trust is taxable to the settlor,[62] we can surmise that the Court will hold taxable to him the income of a trust of his creation, containing a power to revoke to arise on two or three years' notice,[63] on the death of an aged relative with a life expectancy of five years,[64] or on the marriage of an eligible daughter. On the other hand, if the power arises only on the death of a daughter in good health, the existence of the power gives the settlor no real control of the income today. Of course, he may be taxable on the "satisfaction" theory of the *Horst* case, broadly applied, since the income is payable to persons of

[60] Rev. Act of 1924, § 219(g).

[61] See cases collected in MAGILL, TAXABLE INCOME (1936) 279, 280.

[62] Clifford v. Helvering, 309 U. S. 331 (1940), discussed *supra*.

[63] See Helvering v. Elias (cited note 56 *supra*), where the power to revoke arose 6½ years after the creation of the trust.

[64] *Cf.*, however, Corning v. Commissioner of Int. Rev., 104 F. (2d) 329 (C. C. A. 6th, 1939).

his choice. Possibly the Court will limit the application of that test to cases where the income is being paid to members of the settlor's immediate family.

The statute also requires the income to be taxed to the settlor if the power to revoke is vested in a third person, whether alone or in conjunction with the settlor, and the third person does not have "a substantial adverse interest in the disposition of such part of the corpus or the income therefrom." The trustee is not regarded as possessing a substantial adverse interest for this purpose.[65] A contingent interest in the particular part of the corpus may suffice,[66] but the interest in any event must be a substantial one. There is no constitutional difficulty apparent today in holding a settlor taxable on the income of a trust, revocable only by a third person who is not a beneficiary. The donee of the power having been chosen by the settlor may be supposed to be fairly amenable to his wishes; and hence the income is still within the ambit of the settlor's powers.

Since the statute speaks of "power to revest in the grantor title to any part of the corpus," the settlor may retain the power to alter distributive shares of beneficiaries, if none of the income nor corpus can be diverted to himself.[67] In this respect the income-tax provisions differ from the corresponding estate-tax subdivisions.[68] Nevertheless, here again there is the possibility of the Supreme Court's working out a liability aside from that specifically provided. If the settlor wishes to reserve such powers, he had better deny himself additional powers (such as that to control investments) lest he be held to be substantially the owner of the income, under Section 22(a).

[65] Reinecke v. Smith, 289 U. S. 172 (1933).

[66] Shiverick v. Commissioner of Int. Rev., 37 B. T. A. 454 (1938); Stetson v. Commissioner of Int. Rev., 27 B. T. A. 173 (1932).

[67] Knapp v. Hoey, 104 F. (2d) 99 (C. C. A. 2d, 1939).

[68] *Cf.* Int. Rev. Code § 811(d); Porter v. Commissioner of Int. Rev., 288 U. S. 436 (1933).

Trusts for the Grantor's Benefit

Section 167 makes taxable to the settlor the income of two other principal types of trusts: (1) Trusts the income of which may be distributed, or accumulated for future distribution, to the settlor; and (2) trusts the income of which is or may be applied to the payment of premiums on policies of insurance on his life. Like Section 166, this section provides for taxation to the settlor, even though the discretionary power is vested in a third person not adversely interested.

Mr. Justice Cardozo, speaking for a bare majority of the Court in upholding the constitutionality of Section 167 as applied to irrevocable funded insurance trusts,[69] employed reasoning similar to Mr. Justice Stone's in the *Horst* case:[70] that Congress may tax as income a benefit to the taxpayer essentially similar to the economists flow of satisfactions.[71] "A continuing exercise by the settlor of a power to direct the application of the income along pre-determined channels" is the equivalent of ownership of the income. The flow of satisfactions which may be treated as income is not restricted to the satisfaction of *legal* obligations monetary in character. The settlor in the *Wells* case evidently owed no legal obligation to insure several at least of the beneficiaries. Income is annually realized by the settlor of a funded insurance trust, the income being used to pay premiums on his life policies even though he thereafter has no continuing control over the income; in the words of Mr. Justice Cardozo, the income is being used to discharge his pressing social duty.

If the wife of the insured sets up the trust to pay premiums on insurance policies she has taken out on his life, the literal wording of Section 167 does not apply, for the insured is not

[69] Burnet v. Wells, 289 U. S. 670 (1933); MAGILL, TAXABLE INCOME (1936), 237 *et seq.*

[70] Cited note 31 *supra.*

[71] See (1934) 47 HARV. L. REV. 1209, 1277.

the settlor. Nevertheless, if the wife is building up an asset for herself, it seems she can be taxed on the trust income.[72]

If the income of a trust is used to discharge debts of the settlor, he is taxable thereon.[73] Express provisions are hardly required to effect this result, for clearly the settlor reaps as definite a pecuniary benefit as if he had received the trust income directly. If the trust income is used to support minor children, the same reasoning applies;[74] but an additional foundation would need to be found for taxation to the settlor of income of trusts (1) being accumulated for payment to beneficiaries when they reached full age; or (2) being paid to persons whom the settlor owes no duty to support. That foundation may be provided by the *Horst* and *Clifford* philosophy, discussed above. Prior to the *Horst* decision, it had been supposed that the income of a trust accumulated for the benefit of a minor child of the settlor, but not used to support the child, or the income of a trust created by a father for an adult child was not taxable to the settlor. Now one cannot be so sure.

In the early days of the income tax, the Court in *Gould v. Gould*[75] held that alimony paid by a husband to his wife was not taxable income to her; and by way of dictum, that the husband's taxable income was not decreased by the payment. Generally, income is taxable to the recipient; exceptions are cases in which one's obligations are being discharged by the payment to another, or cases in which one retains control over the earning of the income and its payment to another.[76]

[72] To this effect is Commissioner of Int. Rev. v. Morton, 108 F. (2d) 1005 (C. C. A. 7th, 1940); *cf.*, Dunning v. Commissioner of Int. Rev., 36 B. T. A. 1222 (1937), *appeal dismissed*, 97 F. (2d) 999 (C. C. A. 4th, 1938); if *W* uses income of *H's* trust payable to her to pay premiums on his policies assigned to her, income is taxable to *H*.

[73] Helvering v. Blumenthal, 296 U. S. 552 (1935).

[74] Helvering v. Schweitzer, 296 U. S. 551 (1935); Helvering v. Stokes, 296 U. S. 551 (1935).

[75] 245 U. S. 151 (1917).

[76] See MAGILL, TAXABLE INCOME (1936) 398–99.

If the alimony has the sanction of a judicial decree, there is an obligation resting on the husband to pay it; and in any case, the husband may be under a duty to support. On this basis, the Court decided not so long ago in *Douglas v. Willcuts*[77] that the income of a trust set up by the husband for the benefit of a wife about to be divorced, and sanctioned by the divorce decree, was taxable to the husband. If, however, the creation of the trust is in complete satisfaction of the husband's obligation to support, and cannot thereafter be modified, the case is not dissimilar to the settlement of any contract claim by a single payment.[78] The original obligation has been extinguished; and when subsequent payments of income are made, they are not in discharge of any existing duty of support owed by the husband.

On this analysis, the Court held in *Helvering v. Fuller*[79] that the former husband was not taxable on the income of a trust to pay alimony, since the Nevada court retained no power to modify the decree, nor did the settlor underwrite the principal or income from the trust. In *Helvering v. Leonard*[80] and *Helvering v. Fitch*[81] the husband-settlor was held taxable on the income, on the ground that it had not been conclusively shown that, under the applicable state law, the state court had no remaining power to modify the alimony decree. Thus the husband's duty of support had not been completely discharged. Mr. Chief Justice Hughes, Mr. Justice McReynolds and Mr. Justice Roberts dissented without opinion in the *Leonard* case; and Mr. Justice McReynolds in the *Fitch* case. Mr. Justice Reed dissented with an opinion in the *Fuller* case; and concurred specially in the *Leonard* and *Fitch* cases. His premise is that "the basis for

[77] 296 U. S. 1 (1935); MAGILL, TAXABLE INCOME (1936) 242.

[78] See Paul, *Five Years with Douglas v. Willcuts* (1939) 53 HARV. L. REV. 1.

[79] 310 U. S. 69 (1940). See Ray, *The Income Tax on Short Term and Revocable Trusts* (1940), 53 HARV. L. REV. 1322.

[80] 310 U. S. 80 (1940). [81] 309 U. S. 149 (1940).

that decision [*Douglas v. Willcuts*] was the prior appropriation by the creation of the trust, of future income to meet an obligation of the tax-payer." If the local law creates a duty to support, Mr. Justice Reed thinks the trust income should be taxable to the husband, whether or not under the local law, the state court has the power to modify its decree.

Since the majority decisions thus turn on questions of the local law of divorce, a considerable diversity of decisions might be anticipated. Moreover, the chosen line of demarcation—the power of the particular state court to modify its decree—is not particularly easy to draw.[82] One is led, like Mr. Justice Reed, to question the premises for the decisions; but one may well go back of his starting point, *Douglas v. Willcuts,*[83] in seeking a more promising *ratio decidendi.*

The basic reason why payments of income in discharge of the taxpayer's obligations should be taxable to him is the benefit which he may thus derive.[84] The benefit is obvious enough if the recipient of the income of a trust set up by a husband is his creditor, his wife or his minor child to whom or on whose behalf he would otherwise make similar payments. In the latter cases, the decisions have reached a result[85] similar to that reached in Great Britain by statute[86]—the family may fairly be taxed as a unit. If, however, the unity of the family is being broken by a divorce, as one result of which the former wife is to receive income from a trust, the obligation of the husband to support his wife does not seem a very satisfactory reason for taxing to him rather than to the ex-wife this income which he does not and cannot re-

[82] See on this point Mr. Justice Reed's dissent in Helvering v. Fuller, 310 U. S. 69, 76 (1940).

[83] 296 U. S. 1 (1935).

[84] See MAGILL, TAXABLE INCOME (1936) 240–41.

[85] See Helvering v. Schweitzer, 296 U. S. 551 (1935); Helvering v. Stokes, 296 U. S. 551 (1935); MAGILL, TAXABLE INCOME (1936) 242 *et seq.*

[86] See Income Tax Act of 1918, 8 & 9 Geo. V, c. 40, § 8; Gen. Rules 16, 17; Finance Act of 1927, 17 & 18 Geo. V, c. 10, § 42 (9).

ceive. Certainly the arrangement is not designed, as a family settlement unconnected with divorce or separation often is, to reduce the income taxes otherwise payable by the group. Moreover, it is hard to see any real benefit to the ex-husband, year after year, which can properly be said to constitute income to him. There is no such increase in economic worth as would arise from payments to an ordinary creditor. Rather it would seem more equitable that alimony payments should be taxable to the recipient, not the payor; and the income from alimony trusts to the recipient, not the settlor. On this basis, *Gould v. Gould* was a chivalrous, but unfair decision; *Douglas v. Willcuts,* a misapplication of the discharge-of-obligation analysis; and the three recent cases, a logical but undesirable refinement of the *Douglas* case theorem. In other fields the Supreme Court has brushed aside landmarks; it might very properly have developed a new analysis here.

In 1942[87] Congress wisely clarified and improved the law for future years by providing in substance that periodic payments to a wife made pursuant to a decree of divorce or separate maintenance, or an instrument incident thereto (whether or not a trust), should be taxable to the wife, and not to the husband. Payments in support of minor children, however, are not covered by the new provisions. For reasons already stated, the section is intelligent legislation. It is particularly wise in times like these when an individual cannot afford to be taxed on income he does not receive or control, and when, conversely, every individual should be taxed on the income he does receive.

To summarize, then, the use of short-term trusts has been definitely discouraged by the decisions, for the settlor will be taxed upon income which he does not receive and which he may not even control. There is a second disability common

[87] Rev. Act of 1942, § 120.

to other sorts of family trusts: the precise conditions under which the settlor will be taxed or not taxed on the income are not at all clear. Revocable trusts are also discouraged, though perhaps not trusts with powers to come into being upon the happening of an event not within the control of the settlor and not likely to happen soon. Though the reasons for the statute and decisions are clear, a lawyer may still shed a tear at the passing of a legal device conservatively conceived and useful for nontax reasons. Insurance trusts are not so heavily discountenanced, for the settlor is being taxed only on income that is being used at his behest to satisfy what was once an obligation of a sort. Trusts for minors fall into somewhat the same category; the objection here again is in the uncertainty of judicial definition of the extent to which the income is taxable to the father. Alimony trusts are back in good standing for taxable years after 1941.

The broad distinctions drawn by the Congress and the courts make good sense. Demands for revenue are very great. Equality in taxing situations fundamentally similar though legally diverse is most important. One's chief regret is that the Court has sometimes seemed very astigmatic in drawing its lines of distinction, for they are fuzzy, not clean-cut.

Compulsory Joint Returns

The review of the principal methods for dividing assets and income among members of the family indicates that both Congress and the Court have been astute in preventing tax avoidance through a splitting of income among members of a family. If the husband and father retains control of income because he earns it, or because he holds a power of revocation over it, the income is taxable to him, though paid to someone else. If he benefits by the use of income to discharge his pecuniary obligations or even his duty to support, he is still taxable upon it. Moreover, he may be

still taxable on income which he has the satisfaction of seeing paid to persons of his choice, at least within the family group. He probably escapes income taxation if he sells or gives away the income-producing asset; to this extent, his wife has been recognized as an individual and taxpayer distinct from himself. But the sale or gift must be complete with no strings left in the hands of the transferor.

These usual cases of family transfers and settlements then demonstrate little necessity for the proposed change. The statutory provisions now in the law would not be eliminated or simplified, for, as indicated, the trusts and transfers in question are often made in the interests of children as well as of wives. The real basis for the proposal lies in two other considerations: (1) The advantages now accruing to taxpayers living in community-property states; and (2) the theory that the taxable capacities of a husband and wife are more fairly measured by computing the tax on their aggregate income than by computing separate taxes on their individual incomes. The first point has real appeal to taxpayers resident in the forty noncommunity-property states. Granted that a California wife has an interest under local law in her husband's salary as it is earned that a New York wife does not possess in her husband's earnings, it still seems to be true that the control the two husbands may exercise legally and practically over their earnings is much the same. If so, the federal tax on like salaries should be the same, whether earned by residents of California, New York, or Illinois. The joint-return provision is intended to effect this result, in typical governmental fashion, since it brings about equity by increasing the levies applicable to husbands and wives resident in *all* states.

The second basic reason is not one upon which a lawyer can speak with much authority, for it is essentially an economic question. In passing, it may be observed that the pro-

posed provision is one for tax computation; it does not otherwise strike at the independent legal status of married women. She still owns her separate property; she may still pay her share of the total tax; but the provision usually makes her pay more income tax than she used to pay. Is the taxable capacity of a married couple consisting of a husband with $45,000 income and a wife with $5,000 income from a trust set up by her father practically equivalent to that of (a) a husband who earns $50,000, the sole income of himself and his wife, or (b) a bachelor who earns a like amount? Opinions will differ, and many peculiar individual cases can be imagined. For purposes of the rough justice of wartime taxation, however, the proposal does not seem demonstrably unfair. It has been used for many years in Great Britain, where standards of fairness are not greatly different from our own.

The constitutionality of the proposal seems reasonably clear,[88] notwithstanding the *Hoeper* decision[89] invalidating a somewhat similar provision of the Wisconsin state income-tax law. It is not proposed to require the husband to pay the tax on the aggregate income. He cannot accurately contend that he is being taxed on income not his own. The history of the similar provision in Great Britain is some evidence of its reasonableness, and hence of its compliance with standards of due process. Finally, the atmosphere of the *Wells, Clifford,* and *Horst* cases is that the unity of the family may be recognized for tax purposes. Add to that the strong disposition of the present Court to uphold legislative declarations, and there is every probability that the proposal will be sustained. Objections on social or economic grounds may continue to prevail with Congress. It is unlikely that legal objections can be made effective with the Court.

[88] See the long discussion in the Report of the Committee on Ways and Means on H. R. No. 5417. H. R. Rep. No. 1040, 77th Cong., 1st Sess. (1941) 10 *et seq.*, 62 *et seq.*

[89] Hoeper v. Wisconsin, 284 U. S. 206 (1931).

CHAPTER III

GIFT AND DEATH TAXES

Constitutionality of Federal Death Taxation[1]

WHEN the constitutionality of the federal inheritance-tax act of 1898[2] came before the Supreme Court in *Knowlton v. Moore*,[3] the first question considered by Mr. Justice White (after his historical survey of this form of taxation) was:[4]

> Can the Congress of the United States levy a tax of that character? The proposition that it can not rests upon the assumption that, since the transmission of property by death is exclusively subject to the regulating authority of the several states, therefore, the levy by Congress of a tax on inheritances or legacies, in any form, is beyond the power of Congress, and is an interference by the national government with a matter which falls alone within the reach of state legislation.

Mr. Justice White concluded that the point was without merit.

> Under our constitutional system both the national and the state governments, moving in their respective orbits, have a common authority to tax many and diverse objects, but this does not cause the exercise of its lawful attributes by one to be a curtailment of the powers of government of the other, for if it did there would practically be an end of the dual system of government which the constitution established.

[1] This chapter is a consolidation of material which appeared in *Federal Regulation of Family Settlements* (1937) 4 U. of Chi. L. Rev. 265; (1937) 63 J. of Accountancy 40; *The Federal Gift Tax* (1940) 40 Columbia Law Rev. 773. Reproduced by permission of the publishers.

[2] 30 Stat. 448.

[3] 178 U. S. 41 (1900).

[4] At page 56.

A similar question was raised as to the 1916 law,[5] the first of the current series of federal taxes on transfers at death. The 1916 law differed from the 1898 law in imposing an estate tax rather than an inheritance tax;[6] and it was urged that the "tax is cast upon a transfer while it is being effectuated by the state itself and therefore is an intrusion upon its processes, whereas a legacy tax is not imposed until the process was complete." The Court again upheld the federal taxing power,[7] citing *Knowlton v. Moore;* this kind of a tax "'has ever been treated as a duty or excise, because of the particular occasion which gives rise to its levy.' . . . Upon this point a page of history is worth a volume of logic."

Thus was established, on sound doctrinal grounds, the power of Congress to tax successions. Since at its renaissance in 1916, the tax was levied at low rates, the highest bracket being 10 percent of the net estate in excess of $5,000,000,[8] and its provisions were not very inclusive, it can not have had much effect upon the form of successions. But it had great potential power in this respect; raise the rates and elaborate the definitions of the transfers included within the gross estate, as has since been done, and the tax could have quite as much force as any state regulatory statute in determining the time and the character of large dispositions of property. The Treasury, however, does not seem to have extended its studies of the tax much beyond its revenue potentialities; and great as these may be, they are secondary to its social and economic consequences. For these reasons,

[5] 39 Stat. 756, 777.

[6] A tax upon "the exercise of the legal power of transmission of property by will or descent," rather than a tax upon "the legal privilege of taking property by devise or descent." See Stebbins v. Riley, 268 U. S. 137 (1925).

[7] New York Trust Co. v. Eisner, 256 U. S. 345 (1921).

[8] The tax yielded $6,076,575.26 in the fiscal year 1917; receipts reached a peak of $154,043,260.39 in 1921; and thereafter declined with lowered rates to $34,309,724 in 1933. In 1934, $113,138,364 was collected; in 1935, $140,440,682.34; and in 1936, $218,780,753.53, plus $160,058,761.47 from the gift tax. In 1942 the two taxes together produced $432,541,000.

a study of the probable effects of the present tax upon the legal forms of dispositions of estates is pertinent, now that the rates are at their peak in our fiscal history, and the tax is effectively supplemented by a gift tax.

Elaboration of the Estate Tax

The estate tax imposed by the 1916 law was a comparatively simple affair, the definition of the gross estate occupying three subdivisions of Section 202 and half a page. Property of the decedent subject to the payment of charges against his estate and administration expenses; property transferred in contemplation of death, and transfers intended to take effect in possession or enjoyment, at or after death; and property held in joint tenancy or in a tenancy by the entirety were included. The first provision, intended to tax property actually passing at death, was found to permit a leak of revenue, since in some states real estate of the decedent is not subject to the payment of expenses of administration, and, hence, was not included in the gross estate under the original statutory wording.[9] It was accordingly amended to include all property of the decedent to the extent of his interest therein at the time of his death.[10] In addition, any interest in the decedent's property surviving in his spouse in the form of dower, curtesy, or statutory substitutes therefor, was included in the measure of the tax.[11]

More far-reaching changes have been made in the course

[9] See Crooks v. Harrelson, 282 U. S. 55 (1930).

[10] "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside the United States—

"(a) To the extent of the interest therein of the decedent at the time of his death: . . ." INT. REV. CODE § 811 (a).

[11] After the opening paragraph quoted in note 10,

"(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy; . . ."

of the twenty-five years since 1916, in greatly increasing the detail and the scope of the subdivisions which subjected designated *inter vivos* transfers to the estate tax. Congress successively plugged various loopholes which permitted several forms of quasi-testamentary transfers to go tax-free, and was in fact so diligent in this work that, with the addition of the gift tax, many loopholes were plugged twice. To the original four categories of *inter vivos* transfers subjected to the estate tax were added three more, plus a sweeping subdivision intended to make the previous provisions applicable retroactively to prior-completed transfers. These specifically included in the gross estate transfers subject to a power in the decedent alone or in conjunction with another to alter, amend or revoke;[12] property passing under a general

[12] "(d) (1) To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona-fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death; . . .

"(3) For the purposes of this subsection the power to alter, amend, or revoke shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, or revocation takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purposes if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.

"(4) The relinquishment of any such power, not admitted or shown to have been in contemplation of the decedent's death, made within two years prior to his death without such a consideration and affecting the interest or interests (whether arising from one or more transfers or the creation of one or more trusts) of any one beneficiary of a value or aggregate value, at the time of such death, in excess of $5,000, then, to the extent of such excess, such relinquishment or relinquishments shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this subchapter." INT. REV. CODE § 811(d).

power of appointment exercised by the decedent;[13] and the proceeds of life-insurance policies taken out by the decedent upon his own life.[14] Although no new categories of transfers have been inserted since 1926, the wording has been frequently extended in later revenue acts, generally to offset court decisions giving an interpretation to existing law which the Treasury regarded as unduly narrow.[15] In 1942, the subsections on the power of appointment and insurance were rewritten, to make them more specific and inclusive.

The increase in estate-tax rates did not go along *pari passu* with the extension of the scope of the act. In 1916, the top bracket was 10 percent upon the portion of net estates in excess of $5,000,000. Even under war pressure, it became in 1919 only 25 percent of the excess over $10,000,000. In 1924, the rate on this latter bracket became 40 percent, but in 1926, was reduced to 20 percent. In 1932 the rate on this top bracket was again advanced, to 45 percent, and in 1934, to 60 percent. In 1935, additional upper brackets were inserted, and the highest rate became 70 percent upon net estates in excess of $50,000,000.[16] The 1941 Act imposed a rate of 77 percent of the net estate in excess of $10,000,000. The exemption, $50,000 in 1916, was $100,000 in 1926; and is now $60,000.[17] Finally in 1932, the short-lived gift tax of 1924–25

[13] § 811(f), Int. Rev. Code, as revised in 1942, is discussed *infra*, p. 115.

[14] § 811(g), as revised in 1942, is discussed *infra*, p. 112.

[15] Most notable are the series of amendments to what is now Int. Rev. Code § 811(c). On March 2, 1931, the Supreme Court, by a series of per curiam decisions, held that property transferred in trust to pay the settlor the income for his life, with remainders over, need not be included in the gross estate under the existing law. [Burnet v. Northern Trust Co., 283 U. S. 782 (1931); Morsman v. Burnet, 283 U. S. 783 (1931); McCormick v. Burnet, 283 U. S. 784 (1931).] Congress amended the law on the following day to include such a transfer (and others) specifically in the gross estate; and further elaborated the provisions in the Rev. Act of 1932, § 803(a). A similar elaboration occurred in the present § 811(d).

[16] Section 201(a), Rev. Act of 1935, amending § 401(b) of the Rev. Act of 1932, as amended.

[17] Int. Rev. Code § 935(c), as amended in 1942, which eliminated the $40,000 insurance exemption; and increased the general exemption from $40,000 to $60,000.

was revived,[18] and has since been continued, with rates numerically three fourths of the estate-tax rates. Actually, as will be shown, the effective rates are much lower.

In 1924, as the result of complaints directed at the Federal Government's invasion of this field of taxation, hitherto occupied by the states, a provision was introduced[19] giving a credit for state inheritance and estate taxes paid, in an amount not to exceed 25 percent of the federal tax.[20] The amount of the credit was increased in 1926 to 80 percent, coincident with a reduction in the federal rates.[21] It appeared that the Federal Government was about to desert the estate-tax field, with only a parting admonition to the states that their estate and inheritance rates should equal but not exceed four fifths of the low federal rates.[22] But the necessities of the depression ended this strategic retreat by Congress. In 1932, the states having largely adjusted their rates to equal the federal credit exactly, an additional federal estate tax was imposed,[23] to which the credit was inapplicable. It is these additional rates which have since been periodically increased. The 1926 rates are in reality left in effect only for the purpose of the determination of the credit for state taxes.[24] Although the credit, in the case of sizeable estates, does not now exceed 25 percent of the actual federal tax, the state taxes for the most part have been kept within it.

[18] Rev. Act of 1932, §§ 501 *et seq;* now INT. REV. CODE §§ 1000 *et seq.*

[19] Rev. Act of 1924, § 301(b).

[20] The validity of the provision was upheld in Florida v. Mellon, 273 U. S. 12 (1927); See Machen, *The Strange Case of Florida v. Mellon* (1928) 13 CORNELL L. Q. 351; (1928) 16 CALIF. L. REV. 447; (1927) 27 COLUMBIA LAW REV. 462.

[21] Rev. Act of 1926, § 301(b).

[22] The Senate Committee on Finance recommended the repeal of the estate tax in 1926 (SEN. REP. No. 52, 69th Cong., 1st Sess., p. 7). The provisions for an estate tax contained in the House bill were restored in conference, with an increase in the exemption from $50,000 to $100,000. (H. R. REP. No. 356, 69th Cong. 1st Sess., pp. 49–50).

[23] Rev. Act of 1932, § 401.

[24] As to the computation of the credit, see Sec. 81.9, U. S. Treas. Reg. 105.

History and Constitutionality of the Gift Tax

The federal gift tax was the outcome of a minor skirmish in the course of the great engagement in 1924 between forces led by the late Secretary of the Treasury Andrew W. Mellon on the one side, and by Congressman, later Vice President, John N. Garner on the other. Mr. Mellon had proposed a set of income surtax rates, which terminated in a maximum of 25 percent on net incomes in excess of $100,000—thereby cutting existing rates applicable to the upper brackets one third to one half. Mr. Garner advocated surtax rates which reached a maximum of 44 percent at $92,000 net income and over. Mr. Mellon urged that "the high rates now in effect are progressively becoming less productive of revenue. The high rates put pressure on taxpayers to reduce their taxable income, tend to destroy individual initiative and enterprise, and seriously impede the development of productive business."[25] A majority of the Ways and Means Committee accepted this point of view, but on the floor of the House a new schedule of surtax rates similar to the Garner rates was adopted, rising to 50 percent on net incomes over $200,000.[26] At the same time the Democratic minority advocated, and the House adopted, a gift tax in a comparatively mild form. The basic reasons were stated to be (1) that a gift tax is a necessary corollary to an estate tax, to prevent what was termed the "evasion" of the estate tax through *inter vivos* gifts; and (2) that a gift tax is a necessary corollary to an income tax, to prevent the loss of surtax revenue through the splitting of large estates.[27] The gift tax was stricken out by

[25] See letter of November 10, 1923, addressed to Hon. William R. Green, appearing in REP. SEC'Y TREAS. (1923) 6; in part reprinted in H. R. REP. No. 179, 68th Cong., 1st Sess. (1924) 3. See also MELLON, TAXATION: THE PEOPLE'S BUSINESS (1924) Appendix A, and Chapter IV.

[26] The maximum surtax rate of the Revenue Act of 1924 was finally fixed at 40 percent of net incomes in excess of $500,000.

[27] 65 CONG. REC. 3120, 3172–73 (1924).

the Senate Finance Committee, but was inserted by amendment on the floor of the Senate, and ultimately became law on June 2, 1924.

The constitutionality of the gift tax was promptly attacked on various grounds: that it could not be imposed validly upon gifts which had been made from January 1 to June 1, 1924, inclusive, before its approval; that it was a direct tax and not apportioned; and that, in imposing a progressively graduated tax, subject to various exemptions, it violated the due process clause of the Fifth Amendment. In *Blodgett v. Holden*[28] the Court held unanimously that a gift made in January, 1924, was not subject to the tax; four judges held the act invalid insofar as it undertook to tax such a gift, and four held it inapplicable.[29] In *Bromley v. McCaughn,*[30] however, a majority of the Court held the gift tax valid as applied to gifts made after the date of approval of the law. Mr. Justice Stone reasoned that the tax was "laid only upon the exercise of a single one of those powers incident to ownership" and "is clearly distinguishable from a tax which falls upon the owner merely because he is owner." The graduated feature was sustained by analogy to similar provisions of income, estate and inheritance taxes. Mr. Justice Sutherland, Mr. Justice Van Devanter and Mr. Justice Butler dissented, on the grounds that the right to give away one's property is fundamental, and a tax on the gift is essentially a tax on the property. Neither majority nor minority made much of the point that, while the income tax, the estate tax, and the gift tax can each be regarded as a tax on one particular incident of property ownership, in combination they

[28] 275 U. S. 142 (1927).

[29] In Untermyer v. Anderson, 276 U. S. 440 (1928), a majority of the court held the gift tax invalid as applied to a gift made on May 23, 1924, while the conference report on the bill was pending.

[30] 280 U. S. 124 (1929). See (1926) 26 Columbia Law Rev. 852; (1926) 39 Harv. L. Rev. 888; (1926) 74 U. of Pa. L. Rev. 836; (1926) 35 Yale L. J. 1003.

cover certainly many, indeed most, of the significant aspects of ownership. Apparently separate taxes on the various incidents of property ownership are still indirect in the constitutional sense, though a single tax on property ownership would be direct.[31]

Before the Supreme Court had had time to give the gift tax its blessing, however, the Congress had laid it to rest. The fiscal year 1925 had shown a Treasury surplus of over $250 millions, and surpluses were also in sight for 1926 and 1927. Tax reduction was the order of the day, and the gift tax, estimated to produce only $2 millions, was fairly marked for slaughter, particularly since the income surtax rates were to be reduced to a maximum of 20 percent on incomes over $100,000, and the estate-tax rates to a maximum of 20 percent on the excess of the net estate over $10 millions. So the gift tax was repealed as of January 1, 1926. It actually produced $10,693,468 in revenue during the 19 months of its life.[32]

The onset of the depression with federal deficits replacing surpluses led to higher income-tax and estate-tax rates, and to a steady tightening of substantive provisions to prevent avoidance. If, as the Congress thought in 1924, a gift tax was necessary to protect an estate tax with a top rate of 40 percent on estates of over $10 millions, it was much more necessary to protect an estate tax which today reaches 30 percent at $100,000, and 77 percent at $10 millions. The income-tax surtax rates were on their way toward a similar marked increase from the rates of the middle twenties. The return of the gift tax in 1932 was a natural consequence.

[31] Mr. Justice Stone in the majority opinion said: "Even if we assume that a tax levied upon all the uses to which property may be put, or upon the exercise of a single power indispensable to the enjoyment of all others over it, would be in effect a tax upon property, . . . and hence a direct tax requiring apportionment, that is not the case before us." 280 U. S. at 138.

[32] REP. SEC'Y TREAS. (1939) 375.

It has been made a much more effective fiscal device by several changes from the original statute. In the first place, in an endeavor to obtain results similar to an estate tax, the tax was made cumulative upon the transfers by a particular donor. It is payable annually in respect of gifts of the past calendar year; but in determining applicable rates and exemptions, all taxable gifts since 1932 must be taken into account.[33] Second, it applies, not as before to gifts in excess of $50,000, but to gifts of any amount in excess of two independent exemptions. An individual is allowed to exclude the first $3,000 of gifts to any one person during the calendar year, but the exclusion is expressly inapplicable to gifts of future interests.[34] In addition, citizens or residents are granted a single specific exemption of $30,000, which may be taken in whole or in part as the taxpayer chooses in 1932 and subsequent years.[35] The $3,000 annual exclusion (originally $5,000) at first applied, as it does now, to gifts in trust as well as to outright gifts; between 1938 and 1942, however, no annual exclusion was applicable to gifts in trust. The present law facilitates the gradual accumulation of property

[33] The gift tax return is filed on March 15th, to report gifts for the past calendar year. INT. REV. CODE § 1006. A return is required from every individual who made any transfers by gift during the preceding calendar year, other than gifts of not to exceed $3,000 each to any one person or persons. *Ibid.* Information returns by donees and trustees are also required. U. S. Treas. Reg. 79, Art. 21. INT. REV. CODE § 1001 sets forth the rates and the cumulative feature.

As to the 1932 gift tax generally, see (1932) 32 COLUMBIA LAW REV. 1205.

[34] INT. REV. CODE § 1003(b). U. S. Treas. Reg. 79, Art. 11 states: " 'Future interests' is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payment in the future."

The subsection was amended in 1942 to allow the exclusion in the case of gifts in trust.

[35] INT. REV. CODE § 1004(a) (1), as amended in 1942.

in trust free of tax. The Board and courts have been frequently confronted with the problem whether, in the case of a trust for several beneficiaries, one exclusion or several were permissible. Thus a gift in trust for ten beneficiaries was held to carry ten $5,000 exclusions.[36]

With an avowed intention of encouraging *inter vivos* gifts, the rates are numerically three fourths of the effective rates of the estate tax, ranging from 2¼ percent on net gifts not in excess of $5,000, to 57¾ percent on net gifts in excess of $10 millions. In fact, the rates are relatively lower than that. The gift tax applies to the net gift, that is, the amount transferred to the donee, exclusive of the tax itself which is payable by the donor. The estate tax is levied upon the net estate, and there being no deduction for the estate tax itself the tax is thus imposed not only on the assets which are transferred to beneficiaries, but on the funds which will be used to pay the tax. Thus, a net estate of $2,000,000 is subject to total federal and state taxes of about $751,900, and beneficiaries will receive $1,248,100 net. The gift tax on a transfer of $1,248,100 is $287,192, less than half of the estate tax. Hence, if the amount is transferred by gift, the donor or the beneficiaries will have much more for themselves than if it is transferred at death. In the second place, since both the gift tax and the estate tax are levied at progressive rates, and each provides for exemptions, it is sensible policy for any person of considerable estate to make use of both sets of exemptions, and the two sets of rates, by transferring some property by gift during life. In effect, these gifts will be removed from the highest brackets of the estate tax applicable to him, and subjected to the lower brackets of the gift tax, an important saving.

Although the gift tax has approached the estate tax in productivity in only one year, 1936, it has yielded the consid-

[36] McBrier v. Commissioner, 108 F. (2d) 967 (C. C. A. 3d, 1939).

erable sum of $414 millions in the fiscal years 1933 to 1941, inclusive. In the same period, the estate tax produced $2,175 millions.[37]

Property Subject to Gift Tax

The act expressly states that it is applicable to direct or indirect gifts and to transfers in trust, in either case whether the property is tangible or intangible, real or personal.[38] Since the gift tax is a transfer tax, it is applicable to gifts of federal, state, and municipal bonds, even though they are exempt from income or some other forms of taxation.[39] The regulations so provide; but add, however, "a gift of a bond, note, or certificate of indebtedness issued by the Federal Government prior to March 1, 1941, if made by a nonresident alien, not engaged in business in the United States, is not subject to the tax, but a gift by any such nonresident alien of an obligation of the Federal Government issued on or after March 1, 1941, is subject to the tax.[40]

The act goes on to provide that in the case of a nonresident not a United States citizen, the tax shall apply only to transfers of property situated in the United States. The inference is, therefore, that citizens and residents of the United States are taxable upon transfers of any kind of property wherever situated; and the regulations originally adopted this view. The regulations now provide: "Real estate, tangible personal property, and the written evidence of intangible personal property, which is treated as being the property itself are within the United States if physically situated therein."[41] It is then provided that lands are not within the United States unless physically therein, but stock of domestic corporations is property within the United States

[37] Rep. Sec'y Treas. (1941) 485. [38] Int. Rev. Code § 1000(b).

[39] Phipps v. Commissioner, 91 F. (2d) 627 (C. C. A. 10th, 1937), *cert. denied*, 302 U. S. 742; (1937) 50 Harv. L. Rev. 840.

[40] U. S. Treas. Reg. 79, Art. 2. [41] U. S. Treas. Reg. 79, Art. 18.

regardless of the physical location of the certificates. These distinctions are technically sound, since in the case of foreign real estate, for example, the protection afforded by the United States is given to the resident, not the property; and the tax is on the transfer of property.

The act expressly provides,[42] as does the estate-tax act,[43] that stock in a domestic corporation owned and held by a nonresident is deemed property in the United States for purposes of the act. The practical difficulties of collecting a gift tax upon a transfer in Canada by a Canadian to his wife of stock in the United States Steel Corporation already endorsed in bearer form, are obvious.[44] Technically the provision seems valid; practically it has little meaning.

WHAT IS A GIFT?

The gift-tax law, unlike the estate-tax law, does not define in detail the kinds of transfers covered. The bill of particulars is limited to statements that the tax applies whether the gift is direct or indirect, the transfer in trust or otherwise;[45] and that "where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall . . . be deemed a gift."[46]

There have not been many cases on the every-day situations and even the Treasury Regulations are cautiously reticent. The Board has stated in *Blanche S. Ross*[47] that

[42] INT. REV. CODE § 1030(b). [43] INT. REV. CODE § 862(a).

[44] Practical considerations of a similar character have led to the exclusion from income taxation of capital gains realized by a non-resident alien not engaged in business here. See INT. REV. CODE §§ 143(b), 211(a); U. S. Treas. Reg. 103, Art. 212–1.

[45] INT. REV. CODE § 1000(b).

[46] INT. REV. CODE § 1002.

[47] 28 B. T. A. 39, 43 (1933), *appeal dismissed*, 67 F. (2d) 989 (C. A. A. 7th, 1933).

The essential elements of a valid gift *inter vivos* are: (1) An intention on the part of the donor to make the gift; (2) delivery by the donor of the subject-matter of the gift; and (3) acceptance of the gift by the donee. In *Edson v. Lucas,* 40 Fed. (2d) 398, 404, the rule is stated as follows:

"... There must be a donor competent to make the gift, a clear and unmistakable intention on his part to make it, a donee capable of taking the gift, a conveyance, assignment, or transfer sufficient to vest the legal title in the donee, without power of revocation at the will of the donor, and a relinquishment of dominion and control of the subject matter of the gift by delivery to the donee. . . ."[48]

In the *Ross* case, a segregation of bonds by a father and his son in a safe-deposit box used jointly by both, coupled with knowledge and acceptance of the gift by the donees (the children) was thought to be a completed gift, even though the interest was deposited in the donor's account, and the bonds were not removed by the donees until five years later. A gift of a stock certificate indorsed in blank can be effected by delivery,[49] but one court has thought that the execution of a separate assignment, without delivery of the certificates, is not enough.[50] Presumably the law of the state having jurisdiction would determine whether an effective and valid gift had been made. In *Blair v. Commissioner,*[51] (involving the question whether a beneficiary who had assigned part of his

[48] Quoted with approval in MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS, 1941–42, p. 580 n. The board elaborated the same definition in Estate of Lorenzo W. Swope, 41 B. T. A. 213 (1940).

[49] *See* Estate of Lorenzo W. Swope, 41 B. T. A. 213 (1940); *cf.* Adolph Weil, 31 B. T. A. 899 (1934), *aff'd,* 82 F. (2d) 561 (C. C. A. 5th, 1936), *cert. denied,* 299 U. S. 552 (1936), where the Board found that the facts indicated an intent to give to minor children the proceeds of stock after sale, rather than the shares themselves. *See* also Theodore C. Jackson, 32 B. T. A. 470 (1935). The taxpayer was seeking to avoid an income tax on a profit on a stock sale, by contending the shares had been given to his nieces; they had been transferred on the books, but the Board found no intent to give, or relinquishment of control. Oscar G. Joseph, 32 B. T. A. 1192 (1935), is similar.

[50] Richardson v. Commissioner, 126 F. (2d) 562 (C. A. A. 2d, 1942).

[51] 300 U. S. 5, 9, 10 (1937).

interest in the income of a trust was still taxable on the entire income), the Supreme Court said: "The question of the validity of the assignments is a question of local law.... By that law the character of the trust, the nature and extent of the interest of the beneficiary, and the power of the beneficiary to assign that interest in whole or in part, are to be determined." The Court further held that the decision of an intermediate appellate court of the state on these questions was final.

Cross trusts created by two persons benefiting thereby do not constitute such consideration, each for the other, as to obviate the gift tax.[52]

The Treasury regards a gratuitous transfer of property by a corporation to *B* as a gift to *B* from the stockholders.[53] Many income tax cases have involved the question whether particular payments were compensation or gifts.[54] The fact situations vary greatly. In general, a payment by a corporation to its officers or employees has been treated as compensation, not as a gift,[55] but payments by a successor corporation to employees of the predecessor[56] or by stockholders, who had just sold their stock, to the corporate administrative staff[57] have been regarded as gifts. A forgiveness of indebtedness may or may not amount to a gift; for example, if the forgiveness is part of a composition among creditors, ordinarily, at least, no donative intent would be involved.[58]

Two unique recent cases involved transfers in trust by an

[52] Commissioner v. McLean, 127 F. (2d) 942 (C. A. A. 5th, 1942); Helvering v. Robinette,—F. (2d)—(C. C. A. 3d, 1942).

[53] U. S. Treas. Reg. 79, Art. 2(1).

[54] Magill, Taxable Income (1936) 346 *et seq.*

[55] *See* Noel v. Parrott, 15 F. (2d) 669 (C. C. A. 4th, 1926), *cert. denied,* 273 U. S. 754 (1927).

[56] Bogardus v. Commissioner, 302 U. S. 34 (1937).

[57] Jones v. Commissioner, 31 F. (2d) 755 (C. C. A. 3d, 1929).

[58] *Cf.* U. S. Treas. Reg. 103, Art. 22(a)–14.

infant, unrevoked after his majority; and transfers from the income of the estate of an incompetent to her husband and adult children. In the former case, the infant had made the transfer two days before the 1932 gift-tax law was approved; she became of age more than a year later. She did not disaffirm. In answer to the Commissioner's contention that the gift was taxable, because the donor had in substance relinquished a power to revoke after the effective date of the act, her attorneys sought to distinguish powers reserved by the donor from powers imposed by law. The Board accepted their arguments, but the Circuit Court of Appeals for the Third Circuit reversed,[59] on the authority of the *Guggenheim* case,[60] shortly to be discussed. A majority of the Board regarded payments of allowances for maintenance, authorized by a state court, to the dependent husband and adult children of an incompetent as not being gifts, "being in satisfaction of an obligation imposed by law"; but the Circuit Court of Appeals for the Ninth Circuit reversed, apparently because there was no consideration in money or money's worth.[61]

Sanctioned Transfers

A survey of estate and gift taxation in this country leads to two general conclusions: first, that federal taxes are a dominant factor in regulating the form of property dispositions by informed persons possessing large wealth; and second, that Congress has strongly encouraged *inter vivos* gifts, and particular kinds of *inter vivos* gifts. Proof of the first proposition lies in the foregoing introduction. Federal rates are several times as high as the state rates. The credit pro-

[59] Commissioner v. Allen, 108 F. (2d) 961 (C. C. A. 3d, 1939), *cert. denied,* 309 U. S. 680 (1939). (1940) 53 Harv. L. Rev. 690.

[60] Burnet v. Guggenheim, 288 U. S. 280 (1933), discussed on this page, *infra.*

[61] Alice H. Lester, 41 B. T. A. 515, *rev'd.* 119 F. (2d) 383 (C. C. A. 9th, 1941), *cert. denied,* 314 U. S. 641 (1941).

vision has, so far, operated as a ceiling above which the state legislatures in general have not found it politic to push the state rates. Hence the state taxes necessarily occupy a position of subsidiary importance. Moreover, it may be doubted whether any state statutes regulating the form of successions, other than taxes, have so broad an effect upon the transfers of large aggregations of wealth as the present federal estate and gift taxes, with their detailed provisions and high rates. Finally, the facts that the federal gift-tax rates are so much less than the estate-tax rates, and that the latter are very high, has already caused large dispositions of property by gift,[62] and thereby removed so much property from the possible operation of state death duties. So long as the present federal laws continue in force, estates are bound to be whittled down by gifts by their owners during their lives; and the yield and importance of state estate and inheritance taxes will be correspondingly decreased.

A final preliminary observation is that the sanctions of the present provisions of the estate tax and gift tax operate most notably in the cases of large estates, and relatively slightly in the cases of small estates. It can fairly be said that, in the case of net estates under $50,000, transfer taxes have little effect upon the form of disposition. The combined federal and New York estate taxes upon a net estate of $50,000 (before exemptions) will be less than $400. Even in the case of a net estate of $100,000 the combined taxes are around $5,600, after taking the major exemptions. On the other hand, the state and the Federal Government take nearly one third of a net estate of $1,000,000, and 63 percent of a net estate of $10,000,000—amounts necessitating careful consideration of the best methods of estate disposition.

[62] In 1925, with relatively low rates, the gift tax yielded only $7,518,129; and in 1926, $3,175,339. In 1936, the gift tax yielded $160,058,761.47, only $60,000,000 less than the estate tax ($218,780,753.53); in 1941, the yield was $52,000,000.

We come now to the consideration of the precise forms of property disposition which Congress has encouraged and discouraged.

SMALL ANNUAL GIFTS

Small annual gifts of not to exceed $3,000 to any one person are markedly encouraged by a complete exemption from gift taxation.[63] By the same token gifts to several members of the family, rather than to one, are favored. The father with several children is by this means stimulated to build up small estates for each of them by successive annual gifts, whether he makes use of insurance on their lives for their benefit, or of outright gifts. Gifts in trust were mildly discouraged, between 1939 and 1942, by the denial of the exemption in such cases, but now such gifts enjoy the benefit of the exclusion.

It is a curious example of legislative and Treasury failure to adopt a single philosophy of transfer taxation that, while the gift tax in this limited way encourages the distribution of property among many beneficiaries, the estate tax offers no such incentive.[64] An estate passing to a single beneficiary is taxed no more by the federal government than an estate passing to a dozen or a hundred beneficiaries.

INTER VIVOS GIFTS

Secondly, the Treasury and Congress quite strongly urge the owner of an estate to give away the greater part of it dur-

[63] INT. REV. CODE § 1003(b) (3): "In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1943 and subsequent calendar years, the first $3,000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year."

[64] President Roosevelt in 1935 urged the adoption of an inheritance tax in addition to the existing estate tax. (Message to Congress, June 19, 1935, H. R. Doc. No. 229, 74th Cong., 1st Sess., p. 1.) The Senate substituted increased rates in the additional estate tax, because of the numerous difficulties "encountered in designing an inheritance tax even reasonably free from serious administrative difficulties." (SEN. REP. No. 1240, 74th Cong., 1st Sess., p. 8.) The bill as finally passed adopted the Senate's plan.

ing his life; the amount he is urged to give away varies with the size of his estate. Unless he gives some of his property while he lives, he throws away the benefit of the $30,000 cumulative gift-tax exemption,[65] as well as the $3,000 annual exemption for individual gifts just referred to. Instead of transferring $33,000 or more of property tax-free, he transfers it subject to the highest bracket of the estate tax applicable to his estate; and even with a moderate net estate of $500,000, the additional estate taxes due to the failure to make the gift are $10,560. Moreover, by making some sizeable gifts while he lives, the donor obtains the full benefit of the lower brackets of the progressive rate schedules of the two taxes. But additional and more powerful stimuli are provided by the fixing of the gift-tax rates at markedly lower percentages than the estate-tax rates; and by the opportunity to reduce greatly the income taxes payable by the family as a group by means of a division of income-producing property among its members.[66] Although the gift-tax rates are numerically three fourths of the estate-tax rates in the respective brackets, the actual differential is much greater, as shown above.

The government strongly encourages *inter vivos* gifts, through the steeply graduated income-tax rates, and the provisions for separate returns by husband, wife, and children, of the income from individually owned property.[67] An individual owning $2,000,000 of property producing $60,000

[65] INT. REV. CODE § 1004(a).

[66] Chapter II contains a discussion of approved and disapproved methods of effectuating a division of income among members of a family.

[67] There is a similar incentive toward residence in one of the nine community-property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Oklahoma, Texas and Washington), since in these states the wife may return one half her husband's salary for income-tax purposes. The 1942 law (§ 402) eliminated the estate tax advantages formerly enjoyed by residents of these states, by requiring community property to be included in a decedent's estate, except what the survivor can show to be his separate property, or traceable to his earnings.

per year income pays annually $32,492 federal income taxes, and has $27,508 left to spend. If he gave $1,000,000 to his wife or his adult son, the total federal income taxes on the same income would be reduced to $24,408, and the two parties would have $8,084 more for themselves.[68] Even if property has to be sold to pay the gift tax, the combined net incomes after taxes ($32,482) will exceed the previous net income ($27,508). Obviously considerations other than rates of taxation will be taken into account but Congress has provided a powerful incentive toward the adoption of its philosophy that large estates should be distributed while the original owner lives.

Another incentive toward *inter vivos* gifts of property is the practical impossibility of accumulating in the estate an amount of cash and liquid assets sufficient to preserve intact a sizeable business or aggregate of other property. To protect a business worth $5,000,000 from the estate tax, so that it can be transferred intact to beneficiaries, requires a liquid fund of $9,580,000, almost twice the value of the business. To protect a $10,000,000 business, the owner would require the staggering amount of $26,320,000. The reason for these results is, of course, that the gross estate includes the fund, as well as the business property, and the estate tax must be paid out of the gross estate which is taxed. Hence, if a businessman wishes to pass his business to his son intact, the tax laws cause him to arrange to transfer at least some of it while he lives; and in some manner, to arrange for a fund

[68] From the Treasury's point of view this type of case is the best argument for compulsory joint returns of husband and wife: to bring about a parity of income taxation in what the Treasury regards as essentially similar situations. Moreover, a salaried man, not living in a community-property state, cannot effectively split his income with his wife [Lucas v. Earl, 281 U. S. 111 (1930), p. 50 *supra*]; a man of property can.

Computations assume that the $60,000 is *net* income; and do not include the Victory tax.

outside of his estate designed to be used to purchase assets from the executor for the benefit of the son.[69]

Since the gift tax is payable in the present, and the estate tax in the future, it may be urged that their rates can not accurately be compared without the calculation of compound interest on the amount of the gift tax for the period of the donor's expectancy, and that, with this necessary correction, the discrepancy in rates tends to disappear. Nevertheless, the actual incentive toward gifts seems to remain, as the Treasury receipts show. The gifts are apt to be made to members of the family; and the income from the donated property may very well be used for expenditures which the donor would otherwise meet, though he is not legally obligated to do so. The capital used to pay the gift tax may or may not have been income producing. In any event, the loss of income to the donor is apt to be restored in large part by savings in income taxes and in the estate taxes which would apply to any accumulations of income added to the estate. Hence the comparison of the effective rates, without interest, probably indicates the extent of the encouragement of gifts, nearly, if not quite, as well as the comparison in which interest is taken into account.

TRUSTS

The two laws tend to encourage gifts as contrasted with testamentary transfers. The estate-tax law also strongly encourages transfers in trust as contrasted with outright gifts.[70] This is an interesting development to a legal historian who

[69] *Cf.* Wilson v. Bowers, 57 F. (2d) 682 (C. C. A. 2d, 1932); and Lomb v. Sugden, 82 F. (2d) 166 (C. C. A. 2d, 1936) in both of which cross-options to purchase were given during life by the owners of corporate shares. The court held, in substance, that the shares must be valued in the estate at the option prices.

[70] As heretofore indicated, the gift-tax law now encourages small annual gifts in trust, by the allowance of the $3,000 annual exemption as to them.

has observed the numerous devices hitherto adopted to remove or at least loosen the grip of the dead hand upon transferred property. Hitherto, husbands and wives have frequently made mutual wills, each merely transferring his property to the other, and leaving the other free to dispose of the entire estate as he might see fit. Under the present estate-tax laws, unless the two spouses die within five years of each other[71] estates of $1,000,000 and upwards will be reduced more than one half by the taxes payable at the two successive deaths under this form of disposition. There is, therefore, the strongest incentive to the creation of an *inter vivos* trust, the income to be paid to the other spouse, for example, for her life, remainders to designated beneficiaries.[72] The longer the ultimate transfer in fee can be postponed, the greater the saving in death duties.

Trusts Subject to Powers to Revoke or Alter.—The three cases in which the Supreme Court has had occasion to determine whether particular transfers were subject to the gift tax have each involved trusts in which the grantor had reserved a power to alter, amend, or revoke. In *Burnet v. Guggenheim,*[73] the taxpayer had created trusts in 1917 for the benefit of children, reserving a full power of revocation. In 1925, he canceled the power, while the gift tax of 1924 was in effect. The court held that the cancellation effected a taxable transfer, on the grounds that a gift is not consummated until put beyond recall; that "what was of the essence of a transfer had come to be identified more nearly with a change of economic benefits than with technicalities of title." This conclusion appears to be wholly sound. Granted

[71] In which event, the value of the property identified as having been received from the prior decedent, or as having been acquired in exchange therefor, is deducted from the gross estate of the second decedent, but subject to a number of limitations. See INT. REV. CODE. § 812(c).

[72] Or the life tenant spouse may be given a special, though broad, power of appointment. See p. 115 *infra*.

[73] 288 U. S. 280 (1933).

that a revocable trust is a well-known and accepted form of settlement, the problem here is one of selecting either 1917 or 1925 as the single year in which the transfer by gift was made, for there is no feasible method of apportioning the tax between the two years. Until the cancellation of the power of revocation in 1925, it was entirely possible that the settlor might make the gift of corpus a nullity. Hence, it can hardly be said, at least for tax purposes, that a gift had been made prior to 1925. In that year, the relinquishment of the power by the settlor fixed the beneficiaries and clothed them with valuable economic interests which they had not previously possessed.

A much more difficult type of case is that in which the settlor cannot reclaim the property for himself but has retained the power to alter or to add other beneficiaries. Thus the donees are uncertain, but the donor in one sense has parted with the property once and for all. The Supreme Court met this issue in 1939 in the companion cases of *Estate of Sanford v. Commissioner*[74] and *Rasquin v. Humphreys*,[75] concluding that the gift was not completed so long as the donor retained this limited power, but was completed when he relinquished it. The principal ground was that the gift tax supplemented the estate tax; and that property transferred subject to a power to alter beneficiaries had been held by the Court to fall within the donor's gross estate.[76] As an additional reason, the Court cited the secondary liability of the donee for the gift tax—a liability which could not fairly be imposed, when the donee might later be deprived of the donated property. Administrative practice was

[74] 308 U. S. 39 (1939).

[75] 308 U. S. 54 (1939). An earlier decision to the same effect is Hesslein v. Hoey, 91 F. (2d) 954 (C. C. A. 2d, 1937), *cert. denied*, 302 U. S. 756 (1937); see Wales, *"Indian"* Gifts (1939) 34 ILL. L. REV. 119; (1938) 5 U. OF CHI. L. REV. 521; (1938) 23 CORN. L. Q. 464; (1937) 50 HARV. L. REV. 995.

[76] Porter v. Commissioner, 288 U. S. 436 (1933).

thought not to be sufficiently settled even to be persuasive, certainly not to be controlling.[77]

Appealing technical arguments in favor of a contrary conclusion can be made. If the settlor has otherwise irrevocably parted with the property, there is much to be said for the propositions that he has transferred the most substantial of his property interests entirely out of himself; and that since the gift tax is primarily payable by the donor on his transfers by gift (not by donees on their receipts), the tax should attach, even though the donees are not wholly ascertained. Again, it is evident that under the *Sanford* decision gift-tax liability can be avoided, at the time of creation of a trust, by the insertion of phraseology giving the settlor the power of adding new beneficiaries or of changing old ones. Nevertheless, as a matter of long-run policy, the decision is desirable. The most persuasive argument for the Court's view is that advanced by Mr. Justice Stone: the corpus of the trust will be included in the settlor's gross estate if he retains his power until death,[78] and if he relinquishes it, he will be subject to the gift tax.[79] On the premise that the gift tax and the estate tax are intended to be supplementary, it is not desirable that particular forms of *inter vivos* transfers should be discouraged by subjection to both taxes, at the same time that other kinds of transfers bear only one.

As matters stand, then, a transfer in trust, subject to a power to alter or to add beneficiaries other than the settlor, offers the further attraction of freedom from income taxa-

[77] That the administrative practice was a tangled web was shown, among other things, by the fact that this case, involving a gift tax for 1925, was finally disposed of in 1939.

[78] INT. REV. CODE § 811(d) requires the inclusion in the gross estate of property transferred by the decedent in trust subject to a power to "alter, amend, revoke, or terminate." *See* Porter v. United States, note 76 *supra*.

[79] So held in the *Sanford* case itself.

tion to the settlor[80]—a tax which would apply if he had power to revest in himself title to the corpus. The property remains his for gift tax purposes, but is not his for income tax purposes.

It remains to consider the conclusiveness of the principal test applied in the *Sanford* case—whether or not the particular transfer is of a type which would cause the property to be included in the gross estate. In other words, if it appears that the property would be so included, is the assessment of a gift tax on the particular *inter vivos* transfer automatically excluded? This test certainly has some exceptions. Mr. Justice Stone mentions a transfer in contemplation of death as one which would be subject to both taxes;[81] and adds a cryptic sentence: "But Sec. 322 [the provision for a credit of a gift-tax payment against the estate tax] is without application unless there is a gift *inter vivos* which is taxable independently of any requirement that it shall be included in the gross estate." This sentence seems to beg our present question: we are trying to decide what, if any, transfers are taxable independently of their inclusion in the gross estate. In the previous paragraph, Mr. Justice Stone said:

> There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the

[80] INT. REV. CODE § 166 begins: "Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested." In these cases the grantor has no such power.

[81] 308 U. S. 39, at 45. The credit against the estate tax for gift taxes paid now appears in the INT. REV. CODE § 813(a). This credit was not entirely adequate, however, since the credit for state death taxes was decreased thereby. See INT. REV. CODE § 813(b), but the defect was cured by the Rev. Act of 1942, § 410.

donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together.

These sentences are addressed primarily to a case in which the settlor had reserved powers over the disposition of the entire property in question. Will they be given general application to cases in which the transferor has retained a sufficient interest in the property to require its inclusion in his gross estate, but has not retained powers over the ultimate disposition of all of it? Suppose, for example, a husband has caused the creation of a joint tenancy or a tenancy by the entirety in himself and his wife, the husband having supplied the entire consideration. The husband has retained an interest in the property given, which will cause its inclusion at its full value in his gross estate.[82] If Mr. Justice Stone's quoted language is applied very literally, no gift tax attaches. Nevertheless, the wife has clearly acquired a valuable interest at the time the tenancy was created, and her interest is not at all subject to reserved powers in the husband. The value of the gift is not the full value of the property, but both in common parlance and in legal contemplation a completed gift of ascertainable value seems to have been made.

A narrower test than that posed above may be evolved from the consideration of cases of joint tenancies, and of transfers containing reservations by the transferor of various other interests. (These cases will be discussed subsequently in greater detail.) Has the transferor completely relinquished, *inter vivos,* ownership and control of interests in the property having an ascertainable value?[83] If he has, a gift tax may

[82] INT. REV. CODE § 811(e). *See* United States v. Jacobs, 306 U. S. 363 (1939), and cases cited *infra,* notes 120 and 121.

[83] Quoted with approval in Helvering v. Robinette (note 52 *supra*) (Transfer in trust in contemplation of marriage; income to grantor, mother and stepfather; remainder to issue of grantor at 21; in default of issue, to appointees by will of surviving life tenant. *Held,* taxable gift.)

be applied, even though the estate tax may also be applicable. On the whole, this narrower test seems more reasonable than a determination that, except for transfers in contemplation of death, the gift tax only applies if the estate tax does not. For there are a good many instances of transfers during life which for purposes other than gift taxation are everywhere regarded as completed gifts, but which are nevertheless includable in the gross estate. It seems that the gift tax should apply to transfers of this character; and accordingly that the coördination of the gift-tax and estate-tax statutes in these instances should be effected by changes in the latter, not by a judicial interpretation of the former that brings it out of line with the general law.

This brief discussion indicates the present difficulty and uncertainty of determining liability to the gift tax in borderline cases. The Supreme Court has not passed upon the application of the gift tax to other types of transfer. In most cases, a preliminary examination of estate-tax provisions and decisions is essential, in addition to an analysis of the applicability of the gift tax itself. Since the exact scope of the estate tax is still uncertain in many respects and since the gift tax has just arrived at the threshold of that extended litigation of individual cases which will ultimately give its very general terms more exact meaning, the path of interpretation is beset with thorns on both sides. A few more thorns are added by the necessity for consideration of the income tax too, since the gift tax is supposedly supplementary to it as well.

What of a transfer in trust, subject to a power of revocation to arise after 10 years, or after the death of a designated beneficiary? In *Emily Trevor*[84] the settlor, aged 61, had reserved the income of the trust for life, and the power to amend or revoke with the consent of the trustee at any time

[84] 40 B. T. A. 1240 (1939).

after 10 years from the date of the trust. The Board concluded that "the death of the grantor, within a given time, was the indispensable event which would bring the future interests here involved into being, that the transmission of such interests would be by reason of the grantor's death, and that upon such event the property so transferred would be includable in her estate."[85] Hence the Board concluded that there was no completed gift *in praesenti*. In the simpler case in which the settlor had not reserved the income, the conclusion should probably be the same.[86] The settlor has reserved a power which renders the donees uncertain, not as uncertain, however, as in the *Sanford* case, since the settlor's death may intervene before the power is available for exercise. The property probably would fall within the settlor's gross estate.[87] To be sure, the terms of the reservation may make it very unlikely that, as a matter of fact, the settlor will be able to exercise it. Nevertheless, the courts ordinarily do not explore these factual possibilities, but prefer to decide on the basis of the form of the settlement or reservation, a test much easier for administrators as well as for courts to apply.

[85] Citing Klein v. United States, 283 U. S. 231 (1931). *See* also Helvering v. Hallock, 309 U. S. 106.

[86] *Cf.* Emerry May Holden Norweb, 41 B. T. A. 179 (1940) (power to revoke generally, but husband's life estate irrevocable, unless he approved a change. *Held,* gift tax only on value of life estate); Lorraine M. G. Dresselhuys, 40 B. T. A. 30 (1939) (transfer to trustees of funds to be paid to a child when he reached 35, but only if donor's husband or donor consented. *Held,* no present gift).

[87] To this effect is U. S. Treas. Reg. 105, Sec. 81.20. *See* also Katherine B. Albrecht, 27 B. T. A. 1091 (1933). (power to revoke by notice in December, effective the following January 1. *Held,* taxable); Mellon v. Driscoll, U. S. Dist. Ct., W. D. Pa., Feb. 20, 1940 *aff'd,* 117 F. (2d) 477 (1941), *cert. denied,* 313 U. S. 579, 61 Sup. Ct. 1100 (1941). (power to revoke on six months' notice. *Held,* taxable). *Cf.* Day v. Commissioner, 92 F. (2d) 179 (C. C. A. 3d, 1937); Helvering v. Hallock, 309 U. S. 106, 60 Sup. Ct. 444 (1940); Safe Deposit & Trust Co., 41 B. T. A. 580 (1940) (power to revoke if settlor marries. *Held,* trust corpus subject to estate tax.)

A related problem is the gift-tax liability with respect to the annual payments of income to the beneficiaries of a trust, subject to such a power to alter or revoke that its creation does not subject the settlor to a gift tax. Granted that the gift of corpus is incomplete, so that the property must be regarded as still part of the settlor's estate, each transfer of income to the beneficiary appears to be a completed gift. Hence the donor should be taxable thereon. A recent Board decision takes a contrary view, however, four members dissenting.[88] The reasoning of the majority—that until the donor alters or amends the trust, the beneficiary is the owner of the income—seems inadequate in the light of the analysis adopted in the *Sanford* case. Here are completed transfers being made to another during the donor's life out of property which admittedly will be part of his estate when he dies, yet no gift tax is imposed. It is submitted that it is unsafe to rely upon the Board's decision until it is affirmed, or until other similar cases are decided.

Most of the trusts considered in this section are subject to the estate tax, but not to the gift tax. The language of the former is sweeping: the property is subject to inclusion in the gross estate, if at the date of the settlor's death, its enjoyment was subject to any change through the exercise of a power to alter, amend, revoke or terminate, exercisable by the settlor alone or in conjunction with any other person including a beneficiary. The case of a power given by the settlor to a third person alone (not a beneficiary) is not expressly covered; and logical arguments are available against the inclusion of the corpus of such a trust in the settlor's estate.[89] There is a strong likelihood, however, that the Su-

[88] Giles W. Mead, 41 B. T. A. 424 (1940), *appeal dismissed,* 116 F. (2d) 278 (C. C. A. 9th, 1940); Jack L. Warner, 42 B. T. A. 954 (1940) rev'd 127 F. (2d) 913 (C. C. A. 9th, 1942).

[89] For example, that the specific designation in the statute of particular persons excluded others not named.

preme Court would uphold inclusion, on the ground that a third person of the settlor's choice is apt to be amenable to his wishes and hence that the property remains in his control.

Some but not all trusts of this type are discouraged by the taxing acts, primarily through the operation of the income tax. Generally speaking they are all subject to estate taxation, at higher rates than the gift tax, but the settlor may feel that the difference is not an excessive price to pay for the ability to change the trust as family conditions change. But the settlor will have to pay an income tax on income which he does not receive—a grievous burden these days—if he has the power to revest in himself title to corpus. As an alternative, Congress seems to have sanctioned a trust subject to a power to revoke in a beneficiary alone. The creation of such a trust will apparently be subject to a gift tax;[90] but the income will not be taxable to the settlor;[91] and the corpus will apparently not be included in his gross estate.[92]

Trusts with Interests Reserved in the Settlor.—The simplest form of these trusts—income to the settlor for life, remainder to his children—is discouraged in that the value of the gift to the children will be subject to the gift tax,[93] and the value of the entire corpus is includable in the gross estate.[94] Similar results may follow if the form of the gifts is changed to that of a life estate to someone other than the settlor, remainder to him. Another serious difficulty in this latter type of case is to determine both how much of a re-

[90] See U. S. Treas. Reg. 79, Art. 3.

[91] Under the wording of INT. REV. CODE § 166, if the power to revest corpus in the settlor is vested in a third person, the income is taxable to him only when that person does not have a substantial adverse interest in the disposition of this part of the corpus or income.

[92] INT. REV. CODE § 811(d) does not include this case, nor does it seem to be within the spirit of the provision.

[93] The children have been given, irrevocably, a property interest whose value is administratively determinable. A credit for gift taxes paid is now allowable (see note 81), but valuation problems remain.

[94] See INT. REV. CODE § 811(c).

maining interest in the settlor is required as the basis for an estate tax; and, if he has enough of an interest, how much value is to be included in his estate?

Helvering v. Hallock[95] poses these questions, but its verbal pyrotechnics do not answer them. Nevertheless the decision is the last word we have from the Supreme Court, and hence must be thoughtfully appraised.

Helvering v. Hallock was a consolidation of five different cases, the material facts of which differed slightly. It was reached by a divided Court,[96] the majority finding it necessary to overrule two decisions of only five years standing.[97] The three Hallock trusts, part of a separation agreement, provided for income for life to the settlor's wife; upon her death the corpus was to go to the settlor if living, otherwise to the settlor's son and daughter. Under the Cassell trust, part of an antenuptial agreement, the income was to be paid to the prospective wife for her life; upon her death, the corpus and accumulations were to go to the settlor if living, otherwise to the wife. The Bryant trust provided for the payment of the income to the wife for life, then to the settlor if living; upon the death of the survivor, the principal was to be paid to the executors or administrators of the settlor's estate. In each case, the settlor died before his wife. The question was whether the transfers were to be included in his gross estate under Section 302(c) of the Revenue Act of 1926, as transfers to take effect at or after death. The Court, in an opinion by Mr. Justice Frankfurter, which approved

[95] 309 U. S. 106 (1940).

[96] Frankfurter, J., delivered the majority opinion. Hughes, C. J., concurred on the ground that the cases were controlled by Klein v. U. S., 283 U. S. 231 (1931); Roberts, J., and McReynolds, J., dissented, in an opinion by the former.

[97] Helvering v. St. Louis Union Trust Co., 296 U. S. 39 (1935), noted in (1936) 49 HARV. L. REV. 661; Becker v. St. Louis Union Trust Co., 296 U. S. 48 (1935); *Recent Developments in Federal Estate Taxation of Inter Vivos Trusts* (1936) 45 YALE L. J. 684, 690.

and followed *Klein v. United States,*[98] and expressly overruled *Helvering v. St. Louis Trust Co.* and *Becker v. St. Louis Trust Co.,*[99] held that they should be included in the husband's gross estate.

The opinion contains much criticism of the "unwitty diversities of the law of property derived from medieval concepts" and of the *St. Louis Trust* cases for following them, plus a statement of the absence of compelling reasons, in *stare decisis* or interests created in reliance on such precedents, for applying the prior decisions. It is less satisfactory in its citation of the positive reasons for a different rule. Moreover, unfortunately for lawyers who must live with the rule and know its scope, there is almost nothing to indicate its precise extent. The best summary of the Court's reasoning seems to be its quotation from the *Klein* decision:

> It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed.[100]

Although the cases have been sometimes spoken of as involving possibilities of reverter to the settlor, his interest in each case was more substantial. He was to take principal or income, if he survived the life beneficiary, and the passage of principal to others, as in the *Klein* case, depending upon the settlor's prior death. His death was in this respect the generating cause of the vesting of the corpus in possession in these beneficiaries. Hence, there is much to be said for the Chief Justice's conclusion that the decision in the *Klein* case was controlling. But Mr. Justice Frankfurter's main interest was in clearing away what he regarded as the debris of the two *St. Louis Trust* cases. The result reached is sound

[98] 283 U. S. 231 (1931). [99] 296 U. S. 39 and 48 (1935).
[100] 283 U. S. 231, 234 (1931).

as applied to the actual cases decided. To the extent of the remainders, the transfers do in fact take effect in possession or enjoyment at or after the settlor's death. The settlors had retained substantial interests in themselves which in the Hallock and Cassell trusts would operate, if the settlor survived the income beneficiary, his wife, to give him unencumbered ownership of the property. An interest does, therefore, pass out of him at his death. To be sure, it is not worth as much as the fee; and so it seems only the value of what he retained is included in his estate.[101]

More space could be devoted to a consideration of the probable extent of application of the doctrines of the case. In general, the impatience of the majority of the Court with distinctions of the law of property leads one to the belief that the Court will give the decision rather broad application. In particular, does it apply to cases in which the settlor has set up *inter vivos* trusts, providing for the payment to others both of the income and the corpus, but reserving to himself a reversionary interest only if all the designated beneficiaries predecease him? To take a strong, but likely case, suppose that the income beneficiary is the settlor's wife, the remaindermen his three young children. It is evident that, as a practical matter, the settlor's reserved interest is valueless, although of course, a calamity might occur whereby all of the remaindermen would be wiped out. Must the settlor who wishes to provide for such a contingency insert as the contingent beneficiary an exempt institution? Further, to round out the discussion, should a gift tax be applicable to the creation of such a trust? The most satisfactory integration of the two taxes would seem to result from a holding that the gift tax is applicable to the extent

[101] This is not entirely clear from the decision, but seems to have been approved, by the disposition of the lower court judgments. *Cf.* U. S. Treas. Reg. 105, Sec. 81.17.

of the value of interests created in donee-beneficiaries, for certainly valuable irrevocable interests have been created in them. The settlor would have the burden of introducing evidence as to the value of his reserved interest, which, as stated, is rather clearly nil. By a parity of reasoning, the estate tax should not be applied.

It is by no means clear, however, that the lower courts or the Supreme Court will actually reach these results; and hence trust draftsmen must for a time proceed with great caution. The uncertainty extends beyond the field of trusts. The Court of Claims, after much vacillation, finally concluded that the proceeds of insurance policies taken out by the decedent on his own life, and irrevocably assigned to his wife and son, who paid the premiums after the assignment, must be included in his estate, since the policies provided that if he survived the assignees, he and his estate became the beneficiaries.[102] In such a case, the Bureau may seek to apply both a gift tax and an estate tax, at least pending the clarification of the scope of the *Hallock* case. Certainly the *Hallock* case is the beginning, not the end, of litigation as to the meaning, not merely of that deliberately ambiguous phrase "transfers intended to take effect in possession or enjoyment at or after death," but of the insurance provision and perhaps other provisions as well.

[102] Bailey v. U. S., 31 F. Supp. 778 (Ct. Cl. 1940) *appeal for cert. dismissed per stipulation of counsel,* Sept. 27, 1940; noted in (1940) 53 Harv. L. Rev. 1208.

Commissioner v. McLean, 127 F. (2d) 942, 944 (C. C. A. 5th, 1942): "For, since *Sanford* and *Hallock, supra,* came down to confuse and confound followers and expounders of gift tax law, the voices of both board members and circuit judges are merely voices crying in the wilderness, and perhaps until the Supreme Court has spoken authoritatively on the question they would do best to decide the questions posed with as little bewordling and as few reasons as possible." See also Smith v. Shaughnessy, 40 Fed. Supp. 19 (C. C. N. Y. 1941), *rev'd* F. (2d) (C. C. A. 2d, 1942); U. S. v. Frank, Fed. Supp. (D. C. Ill. 1942); Commissioner v. Marshall, 125 F. (2d) 943 (C. C. A. 2d, 1942).

Cf. Helvering v. Michel, 43 B. T. A. 1036 (*id.* 41) *rev'd.* F. (2d) (C. C. A. 7th, 1942).

Alimony Trusts.—In *Douglas v. Willcuts*[103] and more recently in *Helvering v. Fitch*[104] the Supreme Court has held that the income of a trust payable to a divorced wife in lieu of alimony is taxable to the settlor-husband, on the ground that the income is being used to satisfy his duty of support. It was finally decided, however, that the income of an alimony trust is not taxable to the husband-settlor, if the trust operates as a complete discharge of any further obligation to support or to pay alimony.[105] In such a case, the parties may have bargained for this final settlement of the claim for support; and there is much to be said for the taxation of the trust income to the recipient, rather than to the divorced husband.[106] The 1942 Act adopted this view in Section 120. In any event, the creation of such a trust does not seem to be a proper occasion for a gift tax on the settlor. The transfer is not by way of gift, but in settlement or satisfaction of an obligation.[107] Moreover, the transfer is frequently the result of a bargain, and by no means the product of a generous impulse. So far as published rulings and regulations show, the Treasury does not claim a gift tax here; and hence no cases have arisen.

Trusts for Wife and Children.—Following the decision in *Douglas v. Willcuts*,[108] the Supreme Court held *per curiam* that the income of a trust for the maintenance and education of minor children was taxable to a settlor-father.[109] Probably this decision applies only to cases in which the income of the trust is actually so used, not to cases, for example, of the

[103] 296 U. S. 1 (1935). [104] 309 U. S. 149 (1940).

[105] Helvering v. Fuller, 310 U. S. 69 (1940). *Cf.* Helvering v. Leonard, 310 U. S. 80 (1940), decided the same day, *rev'g*, 105 F. (2d) 900 (C. C. A. 2d, 1939).

[106] Paul, *Five Years with Douglas v. Willcuts* (1939) 53 HARV. L. REV. 1.

[107] Of course, to the extent that the trust is set up to make other gratuitous dispositions of income or corpus, the transfer may be taxable.

[108] 296 U. S. 1 (1935).

[109] Helvering v. Schweitzer, 296 U. S. 551 (1935); Helvering v. Stokes, 296 U. S. 551 (1935). See (1935) 48 HARV. L. REV. 1026; (1939) 52 HARV. L. REV. 804.

accumulation of income during minority payable after majority; or cases of capital gains, not currently distributable to the minor.[110] Is the creation of these trusts the occasion for a gift tax? The fact that the income is treated as taxable to the father, as being in discharge of his obligation, may be used as the premise for the conclusion that he has not really parted with the property. The gift tax was originally advocated as a supplement to the income tax, as well as to the estate tax.[111] On this theory, perhaps the settlor-father would become taxable on the transfer when the minor beneficiaries became of age, and the duty to support ceases.[112] It is arguable, however, that the transfer in trust is taxable. The father's duty to support did not oblige him to create trusts, and the trusts were set up essentially with a donative intent, not to satisfy the demands of a creditor. Moreover, the size of the corpus and income of the trusts does not vary exactly with the scope of the obligation. The Treasury may seek to apply the gift tax; probably the estate tax is inapplicable. Here again there is a complete lack of authority.

If the settlor must expend a similar amount of income for a like purpose, these decisions (and Section 167 of the income-tax law, upon which they are a commentary) offer no strong discouragement to the settlor's setting up trusts since the settlor can conveniently retain various managerial powers over the trust corpus. Indirectly, however, other forms of settlement are encouraged, since their tax consequences are less. If the trust is created by one who owes no legal duty of support, as the wife's father or the minor children's mother or grandfather, the income is taxable to the trustee or the recipient, not to the settlor or to the husband

[110] *Cf.* Shanley v. Bowers, 81 F. (2d) 13 (C. C. A. 2d, 1936) (trust for wife).

[111] See note 27, *supra.*

[112] Or the father might be treated as having made a present gift of the value of the property transferred for the child's benefit, discounted for the period of his minority.

and father.[113] Since the latter's income will often be taxable at a higher rate than his wife's or his children's, income taxes will be saved and more income will be available for family expenditure. Again, if the income of a trust is to be accumulated during the minority of the beneficiaries, it is apparently taxable to the trustee, not to the settlor.[114]

All of these legal consequences of the present estate, gift, and income taxes on estates and trusts strongly point toward an era of settled property in this country, a condition of things similar to that now common in England among large property owners.[115] The desire to save wealth for the family, rather than pay it over to the Treasury, will find its expression in settlements of property in trust for as long a term as the rules against perpetuities will permit; and as the time for ultimate distribution approaches, the prospective recipient will be urged to create a new long-term trust of the corpus. We have customarily cared for our children during their minority, and then have sent them out to make their own way without property settlements, unlike the English. This condition of affairs is apt to change, notably in the case of large property owners. The principal check upon it is the very real difficulty, almost impossibility, of building up a new estate of any size, due to the extremely heavy personal income taxes. It will be much easier to conserve existing wealth than to create new fortunes. Moreover, since trust estates are apt to be invested, not embarked in risky business

[113] MAGILL, TAXABLE INCOME, 247; Commissioner v. Yeiser, 75 F. (2d) 956 (C. C. A. 6th, 1935).

[114] It was so decided by the lower courts in the *Stokes* case, note 109, and this point was not taken to the Supreme Court. See 28 B. T. A. 1243 (1933); 79 F. (2d) 256 (C. C. A. 3d, 1935).

[115] For an excellent discussion of the provisions of the English form of will, developed through 300 years' experience, see Kales, *The Will of an English Gentleman of Moderate Fortune* (1907) 19 GREEN BAG 214. These provisions were dictated by the experiments and mistakes of the past, not by taxes; but present necessities, including taxes, dictate a remarkably similar disposition of the estate.

enterprises, one can speculate where equity or risk capital is to come from in the future.

JOINT TENANCIES AND TENANCIES BY THE ENTIRETY

The Treasury Regulations provide:

(8) If *A* with his own funds purchases property and has the title thereto conveyed to himself and *B* as joint tenants, with rights of survivorship, but which rights may be defeated by either party severing his interest, there is a gift to *B* in the amount of one-half the value of such property.[116]

No cases seem to have arisen under this provision. The estate-tax law provides specifically and elaborately for the inclusion of joint interests in the gross estate, excepting, in general, portions originally owned by the survivor, or acquired for value.[117] Hence it is arguable that the reasoning of the *Sanford* case calls for the exclusion from gift taxation of the creation of joint tenancies. On the other hand, if each party has the legal power to sever his interest, it seems clear that a valuable property right has passed to one of the joint tenants upon the gratuitous creation of a joint tenancy by the other. Hence, it is likely that the quoted paragraph of the Treasury Regulations represents an accurate statement of the law on the subject. In passing, it is well to note the Treasury's rather liberal rule as to joint bank accounts:

(4) If *A* creates a joint bank account for himself and *B*, there is a gift to *B* when *B* draws upon the account for his own benefit, to the extent of the amount drawn.[118]

The Treasury's rule as to tenancies by the entirety is as follows:

(7) If a husband with his own funds purchases property and has the title thereto conveyed to himself and wife as tenants by the

[116] U. S. Treas. Reg. 79, Art. 2.

[117] INT. REV. CODE § 811 (e). *See* Gwinn v. Commissioner, 287 U. S. 224 (1932); United States v. Jacobs, 306 U. S. 363 (1939).

[118] U. S. Treas. Reg. 79, Art. 2.

entirety, and under the law of the jurisdiction governing the rights of the tenants there is no right of severance by which either of the tenants, acting alone, can defeat the right of the survivor to the whole of the property, there is a gift to the wife in an amount to be determined by adding to the value of her right, if any, under the law of such jurisdiction to a share of the income or other enjoyment of the property during the joint lives of herself and husband, the value of her right to the whole of the property should she survive him, the value of each of such rights to be determined in accordance with the Actuaries' or Combined Experience Table of Mortality, as extended.[119]

Several decisions of circuit courts of appeals,[120] the latest from the Third Circuit, in substance sustain the Treasury position; the Board has twice taken the contrary view[121] but each time has been reversed. In the *Hart* case, the court pointed out that in Pennsylvania, the wife possesses the property, shares in its rents, and may prevent its attachment for other than joint debts. Hence, by the gift she has obtained a valuable present interest; by the common law is seized of the whole estate; and may ultimately survive to own it in fee. It is true that here again an estate tax is expressly provided for;[122] hence, if the gift tax is merely supplemental to the estate tax, it must yield to the latter. Moreover, it is unfortunate if, by the incidence of both taxes, tenancies of this sort should be discouraged.[123] It may be significant,

[119] *Ibid.*

[120] Lilly v. Smith, 96 F. (2d) 341 (C. C. A. 7th, 1938), *cert. denied,* 305 U. S. 604 (1939), (1938) 17 N. C. L. Rev. 71; Commissioner v. Hart, 106 F. (2d) 269 (C. C. A. 3d, 1939); Commissioner v. Logan, 109 F. (2d), 1014 (C. C. A. 3d, 1940), memorandum following the *Hart* case, *supra.* See (1938) 37 Mich. L. Rev. 340; (1938) 47 Yale L. J. 1213. Hopkins v. Magruder, 122 F. (2d) 693 (C. C. A. 4th, 1941) reaches the same result.

[121] William H. Hart, 36 B. T. A. 1207 (1937) *rev'd* 106 F. (2d) 269 (C. C. A. 3d, 1939); Henry Logan, 37 B. T. A. 1303 (1938), memorandum following the *Hart* case, *supra.* The Board has now changed its position, at least in cases arising in the Third Circuit. J. C. Gutman, 41 B. T. A. 816 (1940).

[122] Int. Rev. Code § 811 (e). See Tyler v. United States, 281 U. S. 497 (1930); Third Nat. Bank & Trust Co. v. White, 287 U. S. 577 (1932).

[123] A credit against the estate tax for gift taxes paid is provided (Int. Rev. Code § 813), as amended by § 410, Rev. Act of 1942.

however, that in these cases, unlike those of trusts subject to powers, the donor has retained in his own hands no power over the property. The wife may not survive to take the fee, but then it will be death and not an exercise of power by the husband, which will deprive her of it. So the gift seems to be sufficiently complete to justify the mode of taxation adopted by the Treasury.[124]

INSURANCE

For years, Congress urged decedents to carry insurance for named beneficiaries (other than the executor) through the device of an additional estate-tax exemption of $40,000,[125] though it did not see fit to encourage insurance to pay estate taxes.[126] Amounts in excess of that sum should preferably be carried by one of the beneficiaries personally, since in such an event the insurance is not taxable upon the insured's death. The courts added the suggestion that if the insured took out the policies, he should not retain incidents of ownership—the power to change the beneficiary, to borrow on the policy, or to surrender it for cash; if he did not, probably the insurance was not taxable in his estate.[127] If he did not retain these powers, his premium payments constituted annual gifts, taxable only if (with any other gifts) they amounted to more than $4,000 per annum per beneficiary.[128] A sizeable estate in insurance could be purchased for this sum.

[124] See approving notes in (1938) 47 YALE L. J. 1213; (1938) 37 MICH. L. REV. 340; (1938) 51 HARV. L. REV. 1120.

[125] INT. REV. CODE § 811(g).

[126] Indeed Congress has rather effectively discouraged such insurance since insurance proceeds receivable by the executor under policies taken out by the decedent upon his own life were all included within the gross estate, without the exemption granted in the case of insurance payable to other beneficiaries. See INT. REV. CODE § 811(g).

[127] Chase Nat. Bank v. U. S., 278 U. S. 327 (1929); Bingham v. U. S., 296 U. S. 211 (1935); (1935) 44 YALE L. J. 1409; (1936) 34 MICH. L. REV. 1207.

[128] U. S. Treas. Reg. 79, Art. 2, examples (5) and (6); Art. 11, *re* the $4,000 exclusion.

The 1942 law changed this situation in two important respects. The $40,000 specific exemption was eliminated; and the general estate tax exemption was increased to $60,000.[129] Section 811 (g), relating to estate taxation of insurance proceeds, was rewritten and elaborated,[130] so that insurance receivable by individual beneficiaries is included in the estate, if the decedent either paid the premiums or possessed incidents of ownership. Insurance on the decedent's life payable to his executor is still included in the estate. Hence insurance no longer enjoys a special sanction. The amendment of the law clarifies it, but seems to make it too inclusive. If an insured does not possess incidents of ownership of the policy, his payments of premiums are simply a series of gifts to the named beneficiaries; but the asset thereby built up is not *his* property, but the property of the beneficiaries. Hence, the proceeds ought not to be included in his estate.

If the insured retains the incidents of ownership of his policy—the right to change the beneficiary, the privilege of borrowing on the policy or surrendering it for cash—the periodical payments of premiums do not constitute gifts to anyone, on the basis of the philosophy of the *Guggenheim* case and its successors. If he surrenders these powers, or assigns them, to the beneficiary, reserving no interest in himself or his estate, the reasoning of the *Guggenheim* and *Sanford* cases[131] leads to the conclusion that he has made a taxable gift to the beneficiary to the extent of the value of the policy at that time.[132] Thereafter, a payment of premiums

[129] § 414, Rev. Act of 1942. [130] § 404, Rev. Act of 1942.

[131] See pp. 94 *et seq., supra,* and notes thereto.

[132] To this effect is U. S. Treas. Reg. 79, Art. 2(5); Blaffer v. Commissioner, 103 F. (2d) 489 (C. C. A. 5th, 1939), *cert. denied,* 308 U. S. 559, 60 Sup. Ct. 91 (1939). The Second Circuit Court of Appeals has recently held that the gift tax valuation of a single premium life insurance policy, given at the time taken out, is the cost to the donor; not the cash surrender value. Guggenheim v. Rasquin, 110 F. (2d) 371 (C. C. A. 2d, 1940), *aff'd,* 312 U. S. 254, 61 Sup. Ct. 507 (1941).

by the insured amounts to a further taxable gift,[133] for so much has passed beyond recall from the donor to the benefit of the beneficiary. These conclusions conflict with the theory of the gift tax as supplementary to the estate tax, when the estate tax is applied to insurance as to which the insured possessed no incidents of ownership when he died.[134]

Since the income of a trust set up by the insured to pay the premiums on his insurance policies is taxable to him,[135] should the transfer of securities to such an irrevocable trust for this purpose be treated as a taxable gift? On the one hand, the income is being used to satisfy the settlor's obligation,[136] and in this sense is not being donated to anyone. On the other hand, the settlor's obligation is at most "social,"[137] not legal; it is not definite in amount; and in any event, the settlor was not obligated to set up a funded trust. The Second Circuit Court of Appeals has held, reversing the Board,[138] that the full value of the corpus of the trust constitutes a taxable gift, without deduction for the capitalized value of the income which will be used to pay premiums, and which will be taxable to the settlor. The Board's decision would have correlated the income tax and the gift tax; the court concluded, following *Higgins v. Commissioner*,[139] that "there

[133] U. S. Treas. Reg. 79, Art. 2(6).

[134] The Treasury regulations on this point have been changed back and forth. At present, the Treasury treats as taxable in the estate insurance on the decedent's life (1) payable to his estate; (2) on which the insured paid the premiums; or (3) as to which he possessed incidents of ownership. If the decedent paid the premiums but had no incidents of ownership, in theory the gift tax should be applicable to the premiums but the estate tax should not apply, for the asset is already owned by the beneficiary; there is no transfer at death. *But see* § 404 of the 1942 law.

[135] INT. REV. CODE § 167.

[136] See the reasoning of Cardozo, J., in Burnet v. Wells, 289 U. S. 670 (1933).

[137] "Insurance for dependents is today in the thought of many a pressing social duty. Even if not a duty, it is a common item in the family budget." Cardozo, J., in Burnet v. Wells, note 136, *supra*.

[138] Beck v. Commissioner, 43 B. T. A. 147 (1940), *rev'd*, 129 F. (2d) 243 (C. C. A. 2d, 1942).

[139] 129 F. (2d) 237 (C. C. A. 1st, 1942).

was no Congressional intention completely to integrate the income, gift and estate taxes." If the result stands, it is a considerable discouragement of funded insurance trusts, for by the creation of such a trust the settlor incurs a gift tax, and does not diminish his taxable income (so far as the trust income is used to pay premiums).

POWERS OF APPOINTMENT

Property passing subject to a power of appointment in the legatee or devisee is taxable in the estate of the donor of the power. If the power is general, its exercise by the donee by will subjects the property to a second estate tax.[140] The 1942 law completely revised the old subsection on powers, so that property subject to a power to appoint will be included in the donee's estate, whether or not he exercises it, unless the power is limited to appoint within a class of persons designated in the law.[141] In this way, the former encouragement of the use of broad powers, technically special in legal character, is eliminated;[142] and the federal law moves in the direction of the usual state statutes.[143]

CHARITABLE GIFTS

Congress has also subsidized gifts *inter vivos* to charities, educational and religious institutions, and certan public organizations, by allowing a deduction for income-tax pur-

[140] See § 811(f), INT. REV. CODE, as amended in 1942.

[141] § 403, Rev. Act of 1942. These persons are the spouses of the donor or donee; descendants of the donee or his spouse; descendants of the donor or his spouse (other than the donee); spouses of descendants; and certain religious, educational and charitable beneficiaries.

[142] See Griswold, *Powers of Appointment and the Federal Estate Tax* (1939) 52 HARV. L. REV. 929; Leach, *id.* (1939) 52 HARV. L. REV. 961.

[143] Generally the state inheritance-tax acts do not distinguish between the exercise of general and special powers, imposing the tax in both cases. See CCH Inheritance, Estate and Gift Tax Service, vol. 4, par. 1540B. See also Bentley, "Inheritance taxation on powers of appointment," 23 Ill. L. Rev. 446 (1929); Simes, "The devolution of title to appointed property," 22 Ill. L. Rev. 480, 508 (1928).

poses[144] as well as for gift-tax purposes.[145] This encouragement may be a conscious development of the general policy of increasing expenditures for public purposes. Bequests to the designated organizations are free from estate tax,[146] but do not affect the income tax either of the decedent or of his estate. A gift, on the other hand, in the case of a wealthy donor will largely consist of funds which would otherwise go to the Treasury. Thus, a gift of $10,000 by a single man with a net income of $100,000 (before the deduction for this gift) will reduce his income tax from $64,060 to $55,784. In other words, the $10,000 gift costs him $1,724 net. Moreover, if the individual in question has a net estate of $10,000,000, the Federal Government will take 77 percent of the $10,000, if it is left to individual beneficiaries at death. Taking into account the estate tax as well, the gift of $10,000 to the designated educational, religious, and charitable institutions actually costs the donor and his family about $425. The balance of the gift is really made by the Treasury.

The present laws operate to discourage gifts to charities, subject to an annuity charged on the gift. It appears that the present value of such a gift will be free from gift tax, but the full value of the property might be included in the estate as a form of transfer intended to take effect in possession or enjoyment at or after death.[147] If the donor wishes to preserve his income he would be wiser to make an outright gift to the charity of his choice, reserving sufficient funds to purchase a life annuity from an insurance company for himself.

[144] Subject to a limitation to 15 percent of the net income, before the charitable deduction. INT. REV. CODE § 23(o).

[145] INT. REV. CODE § 1004(a) (2).

[146] The estate-tax deduction is worded somewhat less broadly than the gift-tax deduction. See INT. REV. CODE § 812(d).

[147] See INT. REV. CODE § 811(c), and decisions by the state courts relative to similar provisions; *e.g., in re* Honeyman's Estate, (1925) 98 N. J. EQ. 638.

Charitable and educational gifts (rather than bequests) receive another form of indirect but effective encouragement from the usual state decisions to the effect that bequests to extra-state charities or educational institutions are not deductible for purposes of the state inheritance tax.[148] The Dartmouth alumnus resident in Illinois who plans to add to the college endowment should exercise his bounty during his life, thereby reducing his federal income taxes, and also his state inheritance taxes. The latter may otherwise be a sizeable sum, since a bequest outside the family takes the highest rate.

Conclusion

On the basis of this discussion of some of the principal types of transfers, it is possible to advance a few conclusions as to transactions preferred and discouraged, so far as federal taxes are concerned.

1. In the case of large estates, the transfer of some property during life is encouraged by the preferential rates of the gift tax and the gift tax exemptions.

2. *Inter vivos* trusts subject to a power to add or alter beneficiaries, but not so as to benefit the settlor, are preferred to trusts subject to a power of revocation. Both are subject to estate taxation, neither to gift taxation; but the income of the latter type of trust is taxable to the settlor, whereas the income of the former is not. *Inter vivos* trusts with a reservation of interests in the settlor are not encouraged, since they may be subject both to the gift tax and the estate tax.

3. Joint tenancies and tenancies by the entirety suffer from the disadvantage of probable double taxation; clear liability to estate tax, to the extent the decedent furnished

[148] See, *e.g.*, People v. O'Donnell 327 Ill. 474 (1927); *cf.* People v. First Nat. Bank of Chicago, 364 Ill. 262 (1936).

the consideration, and probable liability to gift tax also. The credit for gift tax against the estate tax does not completely eliminate the double tax objection.

4. Funded insurance trusts, set up by an insured, are not advantageous, since their income is taxable to the settlor; the gift tax is applicable, at least in part; and an estate tax may be.

5. Trusts for a wife or minor children so far occupy a twilight zone. In many cases, the settlor, father or husband, will remain taxable on the income. The gift tax may nevertheless be applied.

The need for a more exact coördination of the gift tax and the estate tax, advocated years ago by the Treasury, is quite clear. The Supreme Court has assisted the process, by holding the gift tax merely supplemental to the estate tax, in the case of one kind of transfer; but a good deal of the field remains untouched. Moreover, the Congress has more facilities than has the Court for adjusting nice questions of policy, and for splicing the two taxes neatly and exactly. At the proper time, the adjustment of the scope of the income tax to its two neighbors should also be made. Meantime, the gift tax carries much more interest for the lawyer than its comparatively small yield would indicate. Since it may apply to a very wide variety of transactions, its incidence must often be a subject of careful study, and the guide posts are few. There is plenty of scope for the exercise of our best powers of reasoning and analysis, not so much to the end that clients may pay lesser taxes, but that the gift tax may develop as a fair and useful component of the tax system.

Mr. Mellon, writing in 1924, inveighed against the proposal to increase the top bracket of estate-tax rates from 25 to 40 percent.[149] His main argument was that wealthy persons by their savings preserve the liquid capital for underwriting

[149] MELLON, TAXATION: THE PEOPLE'S BUSINESS (1924) 111.

the business expansion of the nation. Out of their hoards new industries can be financed and hazardous ventures authorized, to an extent impossible if wealth were more evenly diveded. Again, he said, estate taxes devoted to the current expenditures of government deplete the total wealth of the country; they are paid out of capital, and when currently spent, the capital is gone.

Eleven years later, President Roosevelt, in the message[150] which put in motion the legislative machinery for the enactment of the 1935 increase in estate-tax rates to a top bracket of 70 percent, said:

> . . . The transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people.
>
> The desire to provide security for one's self and one's family is natural and wholesome, but it is adequately served by a reasonable inheritance. Great accumulations of wealth can not be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others.

Whatever the merits of Mr. Mellon's arguments, it is evident that Congress has turned its back upon them in the succeeding 18 years. Congress has done what it can to encourage the breaking up of large fortunes, by income-tax and estate-tax rates of exceptional severity in the middle and upper brackets. Congress has so far, moreover, strongly encouraged *inter vivos* gifts and gifts in trust by much lighter effective rates of taxation. Capital distributed at an earlier date among children may well yield satisfactory social results. If children must be given large funds while their fathers live if they are to have large funds at all, fathers will

[150] Message to Congress, June 19, 1935 (H. R. Doc. No. 229, 74th Cong. 1st Sess.).

take more thought to the education of children to their responsibilities.

The ultimate result of a generation of gifts in trusts is not clear. Trust funds are not venturesome, they sit by the fire and warm themselves with 3 percent, or less, and safety. A nation of trust beneficiaries would not be the nation of the roaring twenties, but it will be a nation of more equally distributed wealth. Finally, the postwar period will provide a perfect test for Mr. Mellon's thesis. With no large fortunes save old ones, and with individual and corporate reserves depleted, will there still be venture capital available for our enterprise system? Or is an era of government financing of enterprise inevitable?

CHAPTER IV

SOME EFFECTS OF TAXATION ON CORPORATE POLICIES

AMERICAN corporations seem to be caught in the greatest financial pincer-movement in their history. More and heavier federal taxes bear down upon them from the one side and the archaic and inequitable tax structure closes in upon them from the other. Taxes can be loaded on corporations because they do not vote; and their stockholders are not very acutely aware of the effects of the imposts. Thus the proposal of a heavy, even 100 percent tax, on excess profits is regarded as supported by the slogan "no war millionaires." The fact is that few corporate stockholders are or ever can be millionaires. Corporate taxation ought rather to take into account the fact that corporate stockholders run the gamut of capacity to pay. More important is the fact that to draw the line in a statute between the normal profits and the excessive profits of infinitely varied businesses is almost a complete impossibility. Popular education is necessary, but before we can have adequate popular education, there must be better understanding by corporate executives and their advisors of the fundamental philosophy of corporate taxation, as well as of the numerous instances in which present federal tax provisions sanction or discourage particular corporate policies. The problem is not one of corporate tax rates, except that high rates accentuate the defects of a tax structure.

Basic Theories of Corporate Taxation

Taxes on corporations may be justified on either of three distinct theories. First, the forming of a corporation is a privilege granted by the state, and therefore a fee may be charged for it. On the same general theory, it is a privilege to enter a state for the purpose of doing business in corporate form—the corporate creature of another state is not entitled to enter free of charge. Similarly, an annual fee may be exacted, either from a domestic or foreign corporation for the privilege of conducting a business in corporate form. Each of these fees may appropriately be charged by a state. Their imposition by a state is more easily justified than their exaction by the United States, for the several states grant the privileges involved. Nevertheless, the United States, having the power to impose indirect taxes, may tax the privilege of doing business in corporate form.[1] There do not seem to have been studies of the value of these privileges. Hence the cases generally hold that the states (and the United States) are quite free in measuring the value, by taxes.[2] The United States could measure the privilege by a tax on income or on capital stock. It has employed both methods, and now does.

A second theory is that corporate income, like other income, may be subjected to taxation, as a part of a general income tax. How and to whom should it be taxed? At first

[1] Flint v. Stone Tracy Co., 220 U. S. 107 (1911), upholding the corporation excise tax of 1909, measured by net income.

[2] The principal limitations are: States may not interfere with the power of Congress to regulate interstate and foreign commerce; nor may they tax property or income beyond their jurisdiction. Each of these generalities has a huge accretion of interpretative decisions. See McGoldrick v. Berwind-White Coal Mining Co., 309 U. S. 33 (1940), upholding the New York city sales tax as applied to sales of Pennsylvania coal to New York city purchasers; Western Union Tel. Co. v. Kansas, 216 U. S. 1 (1910); and Cudahy Packing Co. v. Hinkle, 278 U. S. 460 (1929), invalidating taxes measured by authorized capital stock.

blush, it might be supposed that a corporation should be treated like an individual taxpayer and should pay rates that increase progressively with total income. But the largest corporations are owned by hundreds of thousands of stockholders, some with large incomes, some with small. Taxes on corporate income are apt to reduce common-stock dividends, and thus are paid indirectly by common stockholders. So a tax which reduces common dividends by half, is in substance a 50 percent tax on the common-stockholder's income, a pretty high rate even in these times. By this process of reasoning, one is led to approve the British method of taxing corporate income: (1) subject corporate income to the normal tax applied to individuals; but (2) give stockholders a credit for taxes already paid on income distributed as dividends; and (3) subject dividends to surtaxes like other income of the recipients. In this way, taxes on corporate income will be gauged according to the capacity to pay of the various individuals who own the corporation—clearly a desirable result—and will bear the same rates of tax as other forms of income.

The third basis for corporate taxation is its excess profits, a basis peculiarly appealing in war time. That excessive profits in times like these should be heavily taxed or indeed confiscated by the government is again a proposition that at first blush seems self-evident. But what are excessive profits? To start at one extreme, are they *all* profits from war contracts? More equitably, they represent perhaps all profits in excess of a fair return on the investment. Here are more fine-sounding words to be defined. What is a fair return? Should the rate be the same for an airplane manufacturer, an automobile manufacturer now making jeeps, and a bolt and nut manufacturer, who is still making bolts and nuts, but only those used in airplanes? And what is the investment, particularly where there is a long corporate history,

involving mergers and consolidations, liquidations, acquisitions of properties, including good will, through stock issues, and so on? If the tax be extended to all corporations, are the excess profits simply those more or less traceable to wartime increases in profits, or are they any excess over some designated rate of return on investment?

It is easier to ask these questions than to answer them, and there are many more to be asked. Perhaps these samples are enough to indicate that the simple, appealing theory of an excess-profits tax becomes very complicated in practice. The statute must draw a line between what are and what are not excessive profits, and not much account can be taken of the peculiarities and diversities of individual business. For example, the present statute allows standard rates of return for all businesses above a designated size, with no general recognition of the differences in risk in varying enterprises. With rates at the peak, this excess-profits tax law is bound to work badly—and does so.

The problems of the excess-profits are so many and so difficult that a separate chapter has been devoted to them.

Capitalization and Tax Equity

We may now return to a consideration of the present federal taxes on corporations (other than the excess-profits tax) in the light of these fundamentals.

1. Since the United States Government has chartered few corporations, it does not have much of a claim, in equity, to taxes on corporations generally for the privilege of doing business in corporate form. Moreover, the states regularly and properly levy such taxes. The case for federal taxation (other than the pressing need for revenue) is chiefly that many or most large corporations do business in more than one state, and that the privilege of engaging in multistate commerce is not only protected by the Federal Government,

but cannot adequately be taxed by the states individually. The federal capital-stock tax and declared value excess-profits tax rest essentially on this basis. Their design is clever, but not very sound. The corporation may declare the value of its capital stock at any figure it chooses, but if earnings exceed 10 percent of the declared value, a special excess-profits tax becomes payable. Thus the corporation will try to fix the declared value at ten times estimated earnings for the next year, not always an easy determination. Moreover, unless a new declaration is allowed every year, the corporation may easily be overtaxed, if earnings unexpectedly rise or fall (for example, because of wartime regulations or changes). The 1942 law grants the privilege of an annual declaration.

Thus the capital-stock tax operates as a disguised income tax, with the added allure of a guessing game. It is not a desirable form of tax, and from time to time the Treasury has advocated its repeal. But it produced a total of some $282 millions in 1942, supposedly more painlessly than a like amount could be obtained from the income tax. Its effect on corporate policies is not very great, but it does add weight to one of the major effects of the income tax: the encouragement of financing by bonds rather than by stock. The net earnings used in computing the declared value excess-profits tax, and thus in determining the declared value for the capital-stock tax, are arrived at after a deduction for interest on indebtedness, but not for dividends. Thus the value of bonds, notes, and debentures are not taxed to the corporation; indeed, they reduce the likelihood of tax. The value of stock, whether common or preferred, is in effect taxed.

2. The income tax on corporations is presently composed of a normal tax slightly graduated on the basis of size; and a surtax with two brackets of 10 and 16 percent. The surtax is a subterfuge to enable the collection of a tax on the inter-

est on federal bonds, which are subject to surtaxes only. For all other purposes, the surtax is merely an addition to the normal tax, now 24 percent in the case of corporations with incomes in excess of about $50,000. Individual stockholders, whether they own preferred or common stock, are subject to the same individual normal taxes and surtaxes on dividend income as on any other items of income. No account is taken of the fact that corporate income has already been heavily taxed as such, and may have been subjected to excess-profits taxation as well. Hence, one result of this structure is to set a very high price on the privilege of doing business in corporate form. Owners of small enterprises must weigh carefully whether the advantages of a corporate charter, chiefly limited liability, are worth the cost in federal (and state) taxes. It may be doubted whether Congress deliberately intended to discourage the use of the corporate form by small business, yet that is certainly the consequence of the present tax laws.

A second sanction, mentioned in connection with the capital-stock tax, is encouragement of debt financing rather than stock financing. For tax purposes, bonds, notes, or debentures are altogether better as a part of corporate capitalization than stock, particularly preferred stock. Interest on debt is deductible from gross income; dividends, preferred or common, are not. Thus a corporation with $500,000 4 percent bonds and $1,000,000 common, fares much better than one with $500,000 4½ percent preferred and $1,000,000 common. To pay the interest charges on the bonds, the first corporation must earn $20,000. To earn the dividend on the preferred, the second corporation must earn around $33,800, even if it is subject to no excess-profits tax at all. The common stockholders of the first corporation are therefore in better shape to receive dividends than those of the second; the prior charges against earnings are less.

The policy thus embodied in the tax law is in direct contrast with that enforced by such regulatory bodies as the Securities and Exchange Commission and state utilities commissions. There the drive has been to reduce debt, to discourage debt financing, to encourage equity financing by all possible means. The publicly regulated corporation is placed in a dilemma. If it retires bonds and issues stock, its financial position, tax-wise, is worsened. It may even come under an excess-profits tax liability which it would not otherwise have had to bear. It may arrive at a situation where further financing for new construction is almost out of the question, because of its low earnings ratio.

All would agree that this situation is undesirable and ought not be perpetuated. The remedy is simple enough, but it would cost some badly needed revenue, which in these times would have to be made up elsewhere. Prior to 1936, dividends were not subjected to the normal tax in the hands of individual shareholders, but only to surtaxes. To be sure, as the years went by, the individual normal tax became less than the corporate, and thus there was some discrimination against dividends. But it was not very serious, for the rates were low. The theory was that, since the corporation had already paid a normal tax on its net earnings, a second normal tax should not be imposed on the same earnings distributed as dividends. The corporation was thus regarded as a conduit for transmitting earnings from the business to its owners, not as a taxpaying unit entirely apart from its owners. This treatment is a correct application of a general income tax. The capacity to pay to which a general income tax should be keyed is the individual capacity to pay, not a corporate capacity. Individuals own the business; they bear its taxes in reduced dividends. For convenience, it is appropriate to collect a normal tax from the corporation on its earnings, but stockholders should be credited with their

pro rata shares of the taxes so paid. They will also pay any individual surtaxes due, as at present. In this way, dividend income will not be discriminated against; it would be treated, in effect, like bond interest. Hence, corporations would be free to choose whether to issue bonds or stock on the basis of good business, not tax, reasons. Finally, if this tax reform could be effected, the present high corporate rates would not bear with such extreme severity on the small shareholder and small corporation.

In conclusion, the present corporate normal income tax and surtax, having nothing to do with individual capacity to pay, is justifiable only as an excise tax for the privilege of doing business in corporate form. So viewed, the rates are excessive for the privilege enjoyed. What is more serious, the tax rests with disproportionate severity upon stockholders with small incomes, and the inequity increases with increases in rates. The system, being unsound to start with, cannot distribute fairly the severe increases in tax burden which corporations have been and will be required to bear. Finally the structure, in its discrimination in favor of debt financing, fosters capitalization of a type generally agreed to be undesirable—a type which, for example, seems to be a major cause of the difficulties from which our railroads have suffered. Granted that a fundamental reform would be expensive, in the end the present policy will be much more expensive to the economy. The system of corporate taxation should therefore be altered to give stockholders a credit for taxes paid by the corporation on the income distributed. To ease the cost of the change, the credit might at first be allowed only with respect to preferred-stock dividends, and only with respect to corporate surtaxes.[3] Ultimately it should be allowed in respect of all corporate dividends and all income taxes paid by the corporation.

[3] Such a credit was granted in the 1942 law to certain public-utility corporations for preferred dividends paid.

Form of the Business Unit

CORPORATE REORGANIZATIONS—MERGERS[4]

Confronted with a series of corporate reorganizations carried through without the benefit of specific statutory provisions, the Supreme Court held in 1921–25 that a stockholder realized income from the exchange of stock in a predecessor company for the stock of a new company or companies, organized to conduct the same enterprise with the same assets.[5] He also realized income from the receipt of shares in a new company in which had been segregated part of the business of the old.[6] In each case, the stockholder had received an interest different in kind from what he had had before—shares of stock in a new and legally distinct entity. In the cases in which the old company remained in existence, and the stockholder received shares in a new company as a dividend, the surplus of the old company was in fact large enough to cover the distribution.

It is of course possible to realize income in property as well as in money. Hence the Court was justified on purely legal grounds in deciding that the year of the receipt of the new securities was an appropriate time for the computation and taxation of any profit which had accumulated in the investment.[7] At the same time, the decisions turn largely on matters of legal form, and hence the distinctions are not ap-

[4] Some of this material originally appeared in an article, *Effects of Taxation on Corporate Policies* (1939) 18 PROC. ACAD. POL. SCI. 74. Reproduced by permission of the publishers.

[5] Cullinan v. Walker, 262 U. S. 134 (1923); Marr v. United States, 268 U. S. 536 (1925); cf. Weiss v. Stearn, 265 U. S. 242 (1924).

[6] United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921).

[7] See MAGILL, TAXABLE INCOME (1936) 52 *et seq.*

Some economists, notably Robert Murray Haig, have defined income as "the money value of the net accretion to economic power between two points of time." Although Dr. Haig might favor an *annual* accounting for this increase in value of assets, *quere* whether he would choose the time of a corporate reorganization as the occasion for such an accounting.

pealing to a layman or to an economist. Either finds it hard to see an occasion for an income tax when there has been no substantial change in the original investment, but merely, for example, the organization of the DuPont Company of Delaware to conduct a part of the business of the DuPont Company of New Jersey.

Viewed merely as instruments of tax policy, then, these decisions were bound to be challenged. Moreover, in the early twenties, Congress regarded business reorganizations as frequently desirable and often necessary. Hence, successive revenue laws contained increasingly liberal provisions, to permit corporations and stockholders to carry through tax free, not only the kinds of reorganizations which the Supreme Court had passed upon, but a number of other kinds. These provisions, among the most complicated in the law, began to appear in 1918, and reached their zenith in 1924.[8] Since 1934, Congressional doubts of the wisdom of the policy have brought about a gradual attrition,[9] but the core remains; and even as late as 1938, additions were made at the request of the Securities and Exchange Commission for the benefit of public utility companies compelled to reorganize under the Public Utility Holding Company Act of 1935.[10] In 1942, these provisions were substantially extended.

There will be no attempt here to treat in more than the most general outline a series of provisions upon which books have been written,[11] but a summary of them will enable us to detect and to evaluate major policies.

[8] Rev. Act of 1918, § 202(b); Rev. Act of 1924, §§ 202, 203, 204.

[9] In 1934, the reorganization definition was sharply modified, and the provision of prior laws permitting a shareholder in one corporate party to a reorganization to receive additional shares in another corporate party, without recognition of gain or loss, was eliminated.

[10] Rev. Act of 1938, Supp. R; amended by § 171, 1942 law.

[11] See, *e. g.*, MILLER, HENDRICKS, and EVERETT, REORGANIZATIONS AND OTHER EXCHANGES IN INCOME TAXATION (1931); BAAR AND MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS (1935). See also Milton Sandberg, *The Income Tax Subsidy to "Reorganizations"* (1938) 38 COLUMBIA LAW REV. 98.

The definition of reorganizations in the Code[12] commences with statutory mergers or consolidations; that is, mergers or consolidations carried out under the applicable state laws. The definition proceeds with the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation. It comprehends also "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred." This comprehensive definition (and I have not quoted all of it) is a background for the really vital subdivisions, which exempt from recognition for tax purposes the profit or loss on specified exchanges—exchanges most of which would result in tax consequences under the Supreme Court decisions referred to. Thus no gain or loss for tax purposes is recognized if securities in one corporate party to a reorganization, Corporation *A*, are exchanged for securities in another corporate party to the reorganization, Corporation *B*.[13] Nor is gain or loss recognized if one corporate party to the reorganization exchanges its property for securities in another corporate party.[14]

On their face, these provisions permit a wide range of readjustments in the corporate structure, without tax consequences. On closer analysis, it is evident that the building-up of corporate structures into larger units is primarily contemplated. Several corporations can be merged or consolidated without the recognition of gain or loss to the stockholders or

[12] INT. REV. CODE § 112(g).
[13] INT. REV. CODE § 112(b) (3).
[14] INT. REV. CODE § 112(b) (4).

the corporations themselves, so long as no "boot" passes.[15] Combinations effected by means of the acquisition by one corporation either of 80 per cent of the stock of another, or of substantially all the properties of another, can likewise be accomplished free from income tax. Under another paragraph,[16] a business enterprise can be transferred from individual ownership into corporate ownership without the recognition of gain or loss. A business originally started with a small capital by an individual owner can grow into a corporation, and then can become either one subsidiary of a chain owned by a holding company, or one of the components of a large merging or consolidated corporation; the original investment of $100,000 in an individual enterprise may have been transmuted into a minority interest, worth many times $100,000, in the stock of the merging corporation. During all these years of corporate history, federal income taxes will have been payable on current income; but if the reorganization provisions have been complied with, the successive and far-reaching changes in the business structure will not have been made the occasion of an income tax, notwithstanding increases in value in the corporate assets, or in the securities issued against them.

Since the reorganization sections are quite detailed, the bar believed for some years that if the statutory conditions were literally complied with, no gain or loss would be recognized in the exchanges involved. The statute was supposed to be a complete charter within itself. In this field, transactions must be planned in advance, and tax liability may well be the deciding factor for or against the plan. There is much to be said for a basic philosophy, at least in this area, that taxes should be pretty exactly determinable in advance.

[15] If "boot" passes, in general any gain is recognized to the extent of the boot. INT. REV. CODE § 112(c).

[16] INT. REV. CODE § 112(b) (5).

The Supreme Court, however, has introduced a good deal of uncertainty, and has made doubtful ventures of all but the simplest forms of reorganizations. First, it is requisite not merely that the reorganization be carried out according to a previously adopted plan, but that it have a "business purpose."[17] In practice, this requirement seems to mean that the plan shall have a business basis, aside from any tax advantages. The new corporations should live their lives, for a reasonable length of time at least, and should have something to do. The proposition is reasonable enough, but obviously it leads to controversies between the Treasury and the taxpayer, since its boundaries cannot be exactly fixed, and since every corporate act these days has some tax significance. Where there are mixed motives, need the business reason be dominant? Does a merger whose principal reason is to save federal and state taxes on the separate companies have a business purpose? Where tax reasons are really business reasons, the plan should be upheld, for it is not an ephemeral arrangement. Generally the business purpose is readily found; the fact that there are tax considerations too ought not to defeat the plan.

A second and more obscure requirement is a "continuity of interest," as between the transferor and transferee.[18] In broad outline, this theory is also supportable. The general reason for nonrecognition of gain or loss in this field is that the stockholder has retained an interest in a different form in a continuing business. But the Treasury in interpreting the Court's philosophy has ruled in particular cases that a transfer of the assets of Corporation *A* to subsidiary *S* of Corporation *B*, in exchange for *B's* stock, is a taxable transaction, not a tax-free reorganization. Had *A* transferred to

[17] Gregory v. Helvering, 293 U. S. 465 (1935).

[18] Groman v. Commissioner, 302 U. S. 82 (1937), discussed in Chapter VI; Helvering v. Bashford, 302 U. S. 454 (1938).

B for *B's* stock, no gain or loss need have been realized; and had *B* later, as a separate transaction, transferred to *S*, no gain or loss need have been realized. The transaction first outlined is merely a telescoping of the next two. There surely is no substantial reason for differentiation. Although the new condition can usually be met, the application of the theory to past transactions has caused much hardship.

The third proposition added by the Court was eliminated by Congress: that an assumption by the transferee of liabilities of the transferor constituted "boot" to the transferor.[19] Transactions between going concerns necessarily involve an assumption of liabilities along with the receipt of the assets. Hence, a broad application of the decision would make the reorganization provisions almost wholly unworkable. The reorganization definition was therefore amended to provide that an assumption of liability should not defeat the reorganization;[20] but an adjustment to the basis may be required.[21]

In summary, the present revenue laws view with indifference the growth of corporate structures in the specified forms—they are not directly encouraged with a lower tax, nor discouraged with a higher tax, except in one major particular to be noted. Moreover, it should be emphasized that the potential gain or loss which is not presently recognized is not completely exempted; the recognition is in reality postponed until the stockholder terminates by sale or the like his investment in the enterprise.[22] On the other hand, the legislative policy over the last twenty years has not really been a passive one, for without the present tax provisions,

[19] U. S. v. Hendler, 303 U. S. 564 (1938).

[20] INT. REV. CODE § 112(g) (1). [21] INT. REV. CODE § 113(a) (6).

[22] This is accomplished by the "basis" section which provides for a carryover to the securities or property received in exchange, with appropriate adjustments, of the cost or other tax basis of the property originally held. INT. REV. CODE § 113(a) (b).

undoubtedly many or most of the mergers, consolidations and other corporate reorganizations would have given rise to immediate tax liabilities under the prior Supreme Court decisions, and therefore would probably not have been consummated at all.

PUBLIC-UTILITY REORGANIZATIONS

The Revenue Act of 1938 properly expanded the reorganization provisions to include various exchanges of properties and securities made pursuant to orders of the Securities and Exchange Commission, under the authority of the Public Utility Holding Company Act of 1935. For example,[23] Holding Company *A* comprises an integrated utility system in region *X*, but also owns the voting stock of Company *B* with transmission lines in region *Y*. Holding Company *M* comprises an integrated system in region *Y*, but also owns the voting stock of Company *N* with a generating plant and transmission lines in region *X*. In obedience to appropriate orders of the Securities and Exchange Commission, Company *B* transfers its transmission lines in region *Y* to Company *N* in exchange for the generating plant and lines of that company in region *X*. No gain or loss to either company is recognized.[24] The philosophy is that, since the Federal Government through its legislation and its administrative agency has compelled the exchanges to be made, it ought not also to collect tolls upon them. As in the case of normal voluntary reorganizations, the statute postpones the recognition of gain or loss until the property is disposed of by sale or the like, but does not eliminate all taxation of accumulated appreciation for all time to come. For our purposes, the noteworthy feature of these sections

[23] This example is substantially that given on page 29 in the Report of the Senate Finance Committee on H. R. 9682 (75th Cong., 3d Sess., Rep. 1567), which became the Revenue Act of 1938.

[24] INT. REV. CODE § 371(b).

is that the tax law has been so drafted as to remove some tax obstacles in the way of carrying out the general legislative policy with respect to public-utility holding companies.

Supplement R has been found to require extension, however, if its general purposes are to be accomplished. Simple exchanges of the sort originally contemplated can probably be carried out only in a few cases. Generally, it will be necessary, for example, to sell a particular subsidiary's stock, and to use the cash either to retire senior securities, or to acquire properties or stock which can be integrated in the system. So long as these transactions are carried out under S. E. C. orders, the exchanges should be tax-free, since they are in the nature of involuntary conversions.[25] The 1942 law embodies amendments of this character.

HOLDING COMPANIES

Although mergers and consolidations have received a form of indirect sanction from the tax laws, holding companies, whether designed for general commercial purposes or to hold personal investments, have been steadily discouraged. So far as business corporations are concerned, the most important of these adverse enactments go back to 1934 and 1936 respectively. Unquestionably they have had profound effects—largely incapable of exact measurement—upon corporate policies. Some provisions designed to discourage personal holding companies were included in the first income-tax law in 1913;[26] they were expanded in scope and in effectiveness in later years, notably in 1934[27] and 1937.[28] In combination with other sections designed to facilitate the

[25] See INT. REV. CODE § 112(f), 113(a) (9), for the treatment of ordinary involuntary conversions as by eminent domain.

[26] Rev. Act of 1913, Sec. II, A, Subd. 2.

[27] By the addition of Sec. 351, defining certain companies to be subjected to an additional tax.

[28] The Revenue Act of 1937 was in large measure aimed at tax avoidance through the use of personal holding companies.

liquidation of personal holding companies,[29] these provisions have undoubtedly brought about the wholesale elimination of such organizations.

From 1918 through 1935, dividends received by one domestic corporation from another were not subject to the corporate normal tax to the recipient corporation. The theory no doubt was that since the earnings distributed as dividends had been taxed to the paying company, they should not be taxed again to the receiving company. To this argument of equity, there may have been added arguments of policy; namely, that holding companies were frequently necessary or at any rate desirable, and that the revenue laws should not dictate their abolition by imposing upon a business organization in the form of holding company and subsidiaries a tax twice as great as that payable by a business organization of the same size, but conducted by means of a single corporation.

In the 1935 law, this situation was changed, so that, beginning in 1936, not 100 percent but only 90 percent of the dividends received by one domestic corporation from another were to be deductible from gross income in arriving at the taxable net income.[30] In 1936, a technical change was made, converting the deduction into a credit; and the taxable portion of dividends received was raised from 10 percent to 15 percent.[31] The provision was retained (with one change) in the 1938 law.[32] The effect is, then, to impose on earnings of subsidiaries distributed in dividends to a parent

[29] Rev. Act of 1938, § 112(b) (7); INT. REV. CODE § 112(b) (6), as to the liquidation of a subsidiary.

[30] Sec. 23(p), Rev. Act of 1934, as amended by Sec. 102(h), Rev. Act of 1935. The provision never in fact became effective, being superseded by the subsection next cited.

[31] Rev. Act of 1936, § 26(b).

[32] Section 26(b) of the Rev. Act of 1938 limited the credit to 85 percent of the adjusted net income of the recipient; as does the same section, INT. REV. CODE.

corporation a tax of approximately 6 percent, a tax which would not be payable at all if the two corporations were merged into one. Hence in considering the form of corporate organization from the tax point of view, it is well to bear in mind that each holding company intervening between the ultimate individual recipient and the corporation whose assets are producing the income must bear this 6 percent additional charge on any dividends received (unless the corporations can file a consolidated return of income, as discussed in the next section). The effect of this additional tax must have been to reduce materially the number of holding companies and also to reduce the number of subsidiaries set up to operate particular branches of the business.

CONSOLIDATED RETURNS

The same result was assisted in another way, by the elimination of consolidated returns. From 1918 through 1933, affiliated corporations[33] were permitted and at times were required to file a single income-tax return, in which all the respective corporate incomes and all the deductions were consolidated, eliminating, however, intercompany transactions. Thus the losses of one subsidiary could be offset against the income of another subsidiary, or of the parent. Irrespective of tax considerations, consolidated income statements and balance sheets are commonly prepared for a parent and its subsidiaries, in order to reflect the actual net income and net worth of the enterprise as a whole. These statements are a tangible recognition of the business fact that, however important it may be to retain the separate legal identities of each of the various subsidiaries, they constitute in reality branches or departments of a single enter-

[33] This term was defined variously in the different laws. See § 240, Rev. Acts of 1918, 1921, 1924, 1926; §§ 141–42, Rev. Act of 1928; § 141, Rev. Act of 1932.

prise. In determining the net income of the enterprise, the incomes and deductions of all of its component parts should be thrown into hotchpot.

The 1934 law, however, eliminated the provision for consolidated returns, except in the cases of railroad corporations,[34] notwithstanding Treasury advocacy of its general retention.[35] The reasons were probably those stated in a subcommittee report:[36] (1) the provisions were particularly beneficial to large corporations; (2) the losses of one corporation could be offset against the gains of another, with a consequent reduction in tax revenue; and (3) intercompany transactions were freed from tax. None of these arguments is convincing as a matter of tax equity. The consolidated return was essentially a recognition for tax purposes of an existing fact: that affiliated corporations are a business unit, and should report as such. The denial of the privilege of filing such a return must be justified, if at all, on the ground that it is socially desirable to discourage business structures consisting of a parent and subsidiary corporations. The tax law does not attack bigness as such, for if the parent and subsidiaries can be and are merged, there need be no tax on the merger, and the merging corporation will enjoy substantially the same tax rates as all other corporations, large and small. It was the holding-company relationship which was subjected to added tolls.

There was a good deal of comment before the war upon the unwillingness of capital to seek investment in new and risky enterprises. In so far as the two tax provisions just noted had any economic effect, they accentuated the trend. For it was common practice to segregate new enterprises and inventions into separate corporations, in order that the

[34] Rev. Act of 1934, § 141.

[35] Statement of the Acting Secretary of the Treasury (1933), p. 12.

[36] Prevention of Tax Avoidance (Preliminary Report of a subcommittee of the Committee on Ways and Means, 1934), p. 10.

owner's entire capital should not be staked on the venture. If this segregation was effected by means of a subsidiary company, the new enterprise incurred an additional tax load, and there was no provision for the deduction of the subsidiary's losses against the incomes of other subsidiaries or of the parent. Indeed, there was no adequate provision for carrying forward and offsetting the subsidiary's losses in one year against its profits in a future year. Finally, the mass of tax-exempt bonds provides strong competition for new commercial investment of any sort. If it be true that there is nothing so timid as a million dollars, how can we expect that large amounts of capital would choose the uncertain return, the added tax burden, and the inadequate arrangements for the deduction of losses attendant upon a new and untried commercial investment, in preference to the Elysian Fields of a steady, though low, return, and partial or complete freedom from any sort of income taxation, offered by governmental securities?

In Section 730, the present excess-profits tax contained (effective from its origin) a provision for consolidated returns. Certainly "excessive profits" cannot be determined unless all the branches of the enterprise are taken into account. Section 730 gives the Commissioner broad authority to make regulations, and has made his pronouncements unassailable by requiring the taxpayer's consent as the price of the privilege of filing a consolidated return. The current drastic increases in corporate surtaxes revived the demand for consolidated returns for income-tax purposes and they were again provided for in Section 159 of the 1942 law subject to an additional tax of 2 percent of surtax net income. It is to be hoped that the new provision will be allowed to stay in the law. The character of corporate structures has been more largely determined for some years by the tax provisions than by the industry of the anti-trust division of the Department of Justice.

PERSONAL HOLDING COMPANIES

The operation of the tax laws in discouraging personal holding companies is so well known in general outline that I shall not dwell upon it at length. In the past two decades, when personal income-tax rates have ranged up to 82 percent and corporate rates have stopped at 19 percent, or less, the strong incentive for the retention of income by corporations owned by wealthy stockholders was apparent. Moreover, the ability to pay which is so often used as a yardstick of a good tax system is personal ability to pay—not the ability of the artificial corporate entities which legal ingenuity sets up between the living individuals who own them and the rest of the world. Hence steps needed to be taken to insure that the income tax paid by or on behalf of an individual was measured, not alone by the income which he had pocketed directly, but by the income from capital or business which he had pigeonholed in one or more personal holding companies. The means now employed to accomplish this general result are twofold. First, the law[37] defines domestic personal holding companies explicitly as corporations meeting two tests; (1) 80 percent of the income must arise from specified investment sources (dividends, interest, royalties, etc.); and (2) more than 50 percent of the stock must be owned by or for not over five individuals and their families. Any income of such companies which is not distributed to shareholders is taxed at rates of 75 and 85 percent in addition to the normal corporation taxes. These rates are, of course, prohibitive. The effect, therefore, is to force either the dissolution of such companies, or the complete distribution of all their earnings each year. There can be little doubt that the personal holding company as defined in the revenue law is a vanishing organization. Some are still left, but their heyday is over for the present.

[37] INT. REV. CODE § 501.

Foreign personal holding companies are somewhat similarly defined,[38] but here the undistributed corporate income is to be included, pro rata, in the tax returns of the individual American stockholders. Thus, the foreign personal holding company no longer serves to reduce its stockholders' taxes; and it, too, may be regarded as a rapidly waning device.

In the second place, surtaxes of 27½ percent and 38½ percent are imposed upon the undistributed income of any corporation, other than the two forms of personal holding companies, if its earnings or profits are permitted to accumulate beyond the reasonable needs of the business.[39] This latter provision has a long history, but not very much to show for it. Ordinary business corporations have little to fear, unless their stock is closely held by wealthy persons, and unless it is pretty clear that the accumulation of earnings by the corporation had little conceivable motivation save tax-dodging.

Corporations can be built out of individual enterprises or partnerships without tax on the accumulated increase in value of the investment. Corporations can be merged or consolidated, with not much additional income tax attributable to increased size.[40] The revenue law sanctions the large unified enterprise with a lower rate of tax and fairer deduction provisions than are accorded to the enterprise broken up into holding company and subsidiaries. Personal holding companies are severely penalized, with a view to driving them out of business. All these provisions are directed primarily to the form of the business unit.

[38] INT. REV. CODE § 331.

[39] INT. REV. CODE § 102; Helvering v. National Grocery Co., 304 U. S. 282 (1938).

[40] The corporation normal tax is, in general, 24 percent. For corporations with net incomes under $25,000, the rates are 15 percent to 19 percent. Surtaxes range from 10 percent to 16 percent.

Conclusion

Even this brief survey has indicated the outstanding characteristic of the present federal taxes on corporations—they are badly designed and needlessly complex. Actually six different taxes are imposed on domestic corporations, and they seem to be levied upon four different theories.[41] There is no apparent reason why the three major taxes to which every business corporation is subject should not be telescoped into two, one of which would be largely borne by stockholders. If this were done, the cost of computing and paying taxes, now a serious item, would be reduced. Moreover, the appraisal of the economic effects of taxes would be much easier to make. We might reasonably expect that this fine-edged tool of taxation would be used more skillfully, if its results were more fully understood.

The two major corporation taxes—the normal tax and surtax on corporate net income and the excess-profits tax—are fundamentally defective, and the defects are emphasized by high rates. The income tax is entirely independent of the individual income tax. Dividends are subject to double taxation; the corporation pays a normal tax and surtax on its net earnings, and its stockholders pay normal taxes and surtaxes on the dividends they receive, whether common or preferred. Corporate income is thus subjected to heavy discriminatory taxation as compared to other income. Financing by debt rather than by stock has been favored by the tax laws, though generally discouraged by the S. E. C., for bond interest is deductible by the corporation from its gross

[41] The capital-stock and excess-profits taxes are evidently levied for the privilege of doing business in the corporate form. The corporate normal tax and surtax are usually justified as parts of the personal income-tax system, although, as indicated above, they are not integrated with it. The taxes imposed by Sec. 102 and by Sec. 500 are designed to prevent avoidance of individual surtaxes. The excess-profits tax is based on the theory that "excessive profits" are open to virtual confiscation by the Treasury.

income, while dividends are not.[42] The results are perilous in times like these. The excess-profits tax does not accurately define excessive profits. For example, the corporation may not deduct the corporation income tax it must pay. The law is filled with provisions granting relief in specialized cases, but it is less than fair in the average case. The relief provisions are so general, so lacking in standards, that their efficacy is dubious. The whole corporate-tax structure requires fundamental revision, the basic features of which would be: (1) to give individual stockholders credit for the income taxes the corporation has paid on its earnings; (2) to relate taxable income and excess profits more closely to corporate income and capital as reported to stockholders. (See Chapter V.)

Since the great growth of the federal tax system has occurred in a little over a quarter-century, there has hardly been time for comprehensive studies of its far-reaching effects. Attention has normally been directed to immediate questions of revenue raising, less attention to tax equity and none at all to long-range consequences. Merely to devise a tax system which operates fairly within itself is a major problem in social engineering. The best-informed and most judicious mind is convinced of its own inadequacy to determine just tax treatment for all sorts and conditions of men, for diverse businesses and forms of organization, large and small, rich and poor. N.A.M.

Since so many complexities are inherent in the tax system itself, extreme prudence would counsel that the tax system should never be used as a vehicle of social or economic reform; the risk of complete failure, due to inability to forecast and evaluate all consequences, is too great. This position, however, goes too far. In my judgment, the recent

[42] Certain public utilities, however, were granted in 1942 a credit for preferred dividends against the surtax; § 133, 1942 law.

amendments to the Revenue Act to ease the tax burden upon utilities compelled to reorganize for example, were fully justified. The amendments will not increase the revenues, and were not proposed for that purpose. Their sole function was openly avowed and well understood: to remove the tax obstacle from the path of an economic policy fully debated and finally agreed upon. Similarly, provisions to foster corporate reserves available after the war may be eminently desirable. The principal danger in proposals of this sort is that their hybrid character will not be understood; or that their probable consequences, quite apart from the revenues involved, will be obscured or inadequately appraised. The purpose of this chapter is to assist an appreciation of the numerous complexities of one of our major public problems—an appreciation which is the first essential to an intelligent solution.

CHAPTER V

THE EXCESS-PROFITS TAX

IN WARTIME, taxation of the excess profits of corporations is a natural policy for nations to follow. Taxes on individuals are unusually heavy. If wages and farm prices are to be controlled, the demand for a ceiling on corporate profits is insistent. No citizen wants to see huge profits made out of war contracts; so profits from these contracts in excess of a stated maximum are first regulated, then heavily taxed. The extension of the same idea to all corporate profits is readily justified: first, because it is hard to distinguish profits more or less due to war activities from other profits; and second, because corporations making more than a normal return are regarded as better able to pay taxes than less profitable enterprises. General approval of President Roosevelt's recommendation in 1940 of "the enactment of a steeply graduated excess profits tax, to be applied to all individuals and all corporate organizations, without discrimination," was evidenced by the passage by Congress less than six weeks after its introduction of an excess-profits tax act, applicable, however, only to corporations, not to individuals. It was a highly complicated act, which has become much more so with amendments in 1941 and 1942.[1]

This chapter will be devoted, not to legal questions of interpretation of the excess-profits tax,[2] but to the utility and

[1] Excess Profits Tax Amendments of 1941, approved March 7, 1941; Rev. Act of 1942, approved October 21, 1942.

[2] See MONTGOMERY, EXCESS PROFITS and OTHER FEDERAL TAXES ON CORPORATIONS 1941–42; MONTGOMERY, CORPORATION TAX HANDBOOKS, 1942–43.

fairness of the impost as a part of the federal tax structure. What advantages does an excess-profits tax possess; what problems have arisen during its brief recent history; can its defects be corrected?

Theory of the Tax

The tax seems to rest on two premises, one particularly applicable to wartime, the other more general. When all able-bodied young men are being drafted for war service and when up to 90 percent of an individual's income may be taken by the government in income taxes, it is fair to draft corporate profits, too, in excess of some reasonable return on the investment. A variation on the same theme, which, however, leads to quite different results, is that the government may fairly take a good part of all profits in wartime that exceed profits in peacetime. Heavy profits from war contracts, whether received by individuals or corporations, are somehow an affront to public morals. They do not stand publicity. The Treasury's share of profits of all kinds may fairly be greatly increased, while the nation is fighting a war. In the second place, are not a corporation's excess profits an excellent measure of its capacity to pay taxes? If it is making no return at all, or a very moderate return on its investment, it should be taxed correspondingly lightly; if it is making excellent profits, should not the Treasury take a higher percentage of them than is collected from its less prosperous neighbors?

Generally speaking, the first premise has been mainly relied upon, for we have employed the excess-profits tax only in 1917–21, and since 1940. Both Secretary Carter Glass and Secretary David F. Houston strongly urged repeal of the tax at the end of the last war. In his annual report for fiscal 1919, Secretary Glass said:

> The Treasury's objections to the excess-profits tax even as a war expedient . . . have been repeatedly voiced before the commit-

tees of the Congress. Still more objectionable is the operation of the excess-profits tax in peace times. It encourages wasteful expenditure, puts a premium on overcapitalization, and a penalty on brains, energy and enterprise, discourages new ventures, and confirms old ventures in their monopolies.

In his report for the following year, Secretary Houston said:

The reasons for the repeal of the excess-profits tax should be convincing even to those who, on grounds of theory or general political philosophy, are in favor of taxes of this nature. The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns—corporations.

Accordingly, the prior excess-profits taxes were repealed as of January 1, 1922.

Both theories supporting the tax rest on the foundation that a corporation may properly be taxed as an entity distinct from its shareholders. This proposition requires further examination. There are frequent proposals from time to time that corporations should be subjected to progressively graduated income taxes, as individuals are; that a corporation with a net income of five million dollars ought to be taxed at a higher rate than one with an income of one million dollars or one hundred thousand dollars. Although for several years, the corporation income tax has employed a slight graduation for the benefit of small companies, in general the corporation tax is and always has been levied at a flat rate. The reason is that corporate net incomes really belong to the individual stockholders, who in fact receive some three-fourths of corporate income as dividends, in good times and bad. It is their individual capacities to pay which an income tax is designed to tap. In this country, cor-

porations with large incomes characteristically have many stockholders, sometimes as many as fifty thousand, a hundred, or several hundred, thousand. Their individual incomes vary widely. A recent study of dividend distributions in 1940 indicates that 47 percent of the total payment was received by nonprofit institutions like hospitals, schools, and churches, by persons with small incomes who did not fill returns, or by persons with net incomes of less than $5,000.[3] To tax the corporation itself is to reduce by so much the net profits distributable in dividends; and in effect to tax the common stockholder correspondingly. A 50 percent tax on the corporation may thus operate as a 50 percent tax on an individual whose effective income-tax rate is much less. He is thus unfairly dealt with, particularly since now he must pay his full normal tax and surtaxes on any dividends received. (This problem of fairness in taxing corporate profits and dividends is also discussed in Chapters I and IV.) Likewise, the taxation of corporate income at progressive rates may result in the imposition of rates in effect higher on $100 in dividends received by a small stockholder in a large corporation than on $1,000 or $10,000 dividends received by a man with a large income, who owns all or part of a small corporation. Hence, the fairest method of taxation of corporate income seems to be one whereby the tax paid by the corporation is regarded as paid on behalf of individual stockholders to the extent of dividends received. In other words, the tax on dividends should be withheld at the source, and stockholders should be given credit for it on their personal returns.

An excess-profits tax certainly does not conform to this reasoning. Stockholders will have made their investments at different times, when rates of return differed widely. Some

[3] National City Bank (New York) letter May, 1942; TAX FOUNDATION FACTS AND FIGURES IN WAR FINANCE (1942) 35.

may be the original founders of the enterprise, who, if it has been successful, are reaping an excellent return on the investment. Others bought stock recently, expecting current dividends to produce a steady 5 or 6 percent return. An excess-profits tax on the corporation takes no account whatever of the investments of present stockholders, and its rates reduce all common dividends alike, without regard to the respective incomes of recipients, or their rates of return. Individual capacity to pay has no place in the computation of the tax.

Is the tax, then, completely unjustifiable? Probably most of us would not go quite so far. The fact is that here there is a clash between fundamental philosophies, each of which has its virtues. The excess-profits tax is justifiable not so much as a tax, for it offends against the basic criteria of fairness, and simplicity and economy in administration. It is essentially a regulatory device, to insure that government in particular and the individual consumer also shall be able to acquire their needs at minimum prices. We have direct price control, too; but the excess-profits tax and the high surtaxes catch corporate or individual profits which somehow have eluded its meshes. So viewed, the theory of the tax (whatever its imperfections in actual operation) seems to be sound in times of war. (In times of peace, one may feel that less stringent regulation of profits will be generally better for industrial development.) It follows, of course, that the tax must be very carefully drawn, so that normal, reasonable profits are not in fact taken.

A different form of statement is that the government is a partner of every individual and of every enterprise. When the government assumes the costs of war, it is entitled to a larger share of the profits of business, certainly of business which is war-produced, secondly of business which is war-stimulated. It takes these profits on the same footing that

stockholders do, because of its interest in and protection of the corporation itself. The corresponding reduction in corporate distributions to individuals is not by virtue of a tax on them; the senior partner, the government, has claimed the bulk of profits attributable to war activities and of profits in excess of a reasonable return on the money or property originally invested.

The Determination of Excess Profits

The rationalization of a persuasive basis for the tax in wartime is not difficult, for one is painting with a broad brush. The serious problem is to give these theories specific application, to define such words as "normal" or "reasonable" return, "investment," "war-profits." A preliminary question is whether the concern of the tax is (1) the excess of profits during the war period over peace times, or (2) an excessive return on the investment. There are companies with high rates of return on the investment (soft-drink companies, for example), whose success is not particularly attributable to the war; earnings have continued relatively stable, or their growth is due to other causes. At the other extreme are companies, like some steel companies, with a heavy investment and a relatively low rate of return, due almost wholly to war contracts. The Treasury long advocated the second method as the sole definition of excessive profits—a return on invested capital in excess of some stated percentage, say 7 or 8 percent; or a percentage determined by the corporation's rate of return during a base period, but not in excess of a stated maximum. The present law, however, adopted both definitions, and gives the corporation the benefit of the method that produces the lesser tax.[4]

The first method is better calculated to get at profits having some of their roots in the war; the second smacks

[4] INT. REV. CODE § 712(a).

more of such government regulation as has long been applied to utilities. As time has gone by, the Treasury has evidently become more reconciled to the alternative bases contained in the law. Invested capital is often hard to arrive at, if the company has a long history; earnings for the base period and for the current year are more easily determined, and have been arrived at for income-tax purposes anyway. Moreover, statutory invested capital is not the capital and surplus of the business as reported to stockholders, nor the actual value of the present earning assets. Again, since the law makes no provision for differences in risk in different enterprises, and permits only a meager standard return on invested capital, it would work quite unfairly in many cases. The alternative method now employed produces widely varying and inequitable results as between businesses, but it is still preferable to the requirement of a single rigid standard.

Since the tax is now imposed at a very high rate, it is most important that the calculation of the statutory "excess profits" should be fair and accurate. If it is not, the tax will be destructive to business, whatever its immediate return to the Treasury. We must therefore survey the two methods of computing excess profits, not in elaborate legal detail, but sufficiently closely to form some opinions as to the equity of the tax.

INVESTED CAPITAL CREDIT

Invested capital consists of money and property paid in for stock (or as a capital contribution), accumulated earnings and profits, and 50 percent of borrowed capital.[5] Many adjustments must be made, the most important of which is, perhaps, the reduction in invested capital for amounts distributed in past years which did not come out of the corpo-

[5] INT. REV. CODE §§ 714–20.

ration's earnings and profits.[6] Property paid in must be included at its tax basis.[7] If the corporation was itself a product of a so-called "tax-free" reorganization[8] (for example, a merger or a consolidation), or if it acquired the assets of another corporation in this way (as by issuing some of its stock therefor), the value of the property for invested capital purposes is its "basis" (generally cost) to the predecessor corporation, not to the present one. Or if the predecessor acquired the assets in a tax-free reorganization, the "basis" goes back another step, and so on until the property is traced back to an original acquisition for cash or the like in a taxable transaction. If the present corporation has much of a history, the process of determining its invested capital is as difficult as it sounds, involving an analysis of the mode of acquisition of each item of the present assets. It is evident that there is ample room for disagreement between the Treasury and the taxpayer both as to the facts of many of these transactions completed years ago, and the law applicable to them. To cite a simple case, the law as to reorganizations and other subjects has been greatly changed from time to time. It may be a matter of moment to determine whether a particular reorganization occurred in 1916, 1917 or 1918, or in 1923 or 1924, yet practically impossible to fix the date with certainty. Examples of the difficulty of computing invested capital can be multiplied indefinitely. The first objection to the excess-profits tax is, then, that corporations employing the invested-capital credit face years of controversy and litigation, as well as large initial expense for lawyers and accountants to make analyses and computations.

Although there is some theoretical tax justice in holding the present corporation to a "basis" of assets much less than the value of the stock given for them (and less than present

[6] Int. Rev. Code § 718(b). [7] Int. Rev. Code 718(a) (2).

[8] Defined in Sec. 112(g), Int. Rev. Code; and see Chapter IV herein.

worth), because no tax was paid by the seller on his paper profit at the time of the acquisition of assets from him, the actual results are quite unfair. In our supposed case, the present corporation actually paid the then worth of its stock for the assets (say, $1,000,000), and being a purchaser, it escaped no tax on the transaction for none was applicable to it. Its investment in a real sense is $1,000,000, not the original cost of the property to someone else. The fact that the original owner paid no tax on the transfer seems immaterial, particularly when it is probable that in most cases he acquired only a minority interest in the present corporation, which he later disposed of. Moreover, as a practical matter, the tax which by Congressional fiat was not charged on the previous transaction is almost certainly much less than the tax thereby incurred today.

The converse case is also possible: a corporation with a tax basis for assets far in excess of their present worth, or even their worth when acquired. Hence a second objection to the present definition of invested capital is that it neither requires nor allows the taxpaying corporation to use its own cost basis in computing the investment at stake in the enterprise.

Depreciation must be deducted, as account of it has been taken for income-tax purposes in the past; but not infrequently the corporation discovers that it has perfectly good buildings, machines and equipment in active use today, which stand on the tax books of account at zero or not much better. The depreciation taken in the past and allowed by the Treasury was actually too high. There was a tax saving in the past on this score, but it is not comparable to the tax loss today. Similarly distributions to stockholders out of earnings as shown by the ordinary books of account may not have been out of earnings according to the tax accounts. Invested capital must be reduced accordingly.

These are some of the simpler and more obvious difficulties with the invested-capital method of computing the excess-profits tax credit. What the law should provide is debatable. It is evident, however, that statutory invested capital has no necessary relation to the cost of the assets to the present corporation; and certainly none to their present value, or to capital and surplus as shown on the published balance sheets. Present stockholders may be severely penalized today on account of corporate transactions or acts of management years before they acquired any interest in the corporation. This result is made practically certain by the low rates of permissible return allowed by the statute, now 5 to 8 percent. There will be numerous cases in which corporations show a moderate return on their published capital and surplus and nevertheless cannot pay common dividends at all because interest and preferred dividends mop up all available earnings after taxes.

AVERAGE-EARNINGS CREDIT

The average-earnings method of computing excessive profits allows the taxpayer a credit of 95 percent of its average of earnings for the years 1936–39, again with many adjustments.[9] Here the computation is much simpler than the calculation of invested capital, and it is theoretically better adapted to the determination of profits more or less due to the war. The difficulties are problems of equity, rather than of law. Generally the method tends strongly to favor the well-established corporation with a steady income as against its smaller competitor whose income has been rapidly increasing in the base years and since.[10] The former may have much larger profits, a much larger invested capital,

[9] INT. REV. CODE §§ 713, 711(a) (1).

[10] See, however, the growth provision in Sec. 713(f), INT. REV. CODE; Magill, *Relief from Excess Profits Tax* (1941) 89 U. of PA. L. REV. 853–54.

and altogether a much stronger financial position, and still pay decidedly less excess-profits tax. The well-established corporation with a steady income is also favored as against a feast-and-famine enterprise, one whose large earnings in 1942, for example, contrast with deficits in 1936 or 1938. The years 1936–39 were not notably representative years; they were doubtless selected because they were recent, immediately preceding the imposition of the tax. They may be very unrepresentative in the cases of cyclical businesses, or businesses which in that period happened to be going through some kind of readjustment. A corporation may find that another four-year period, or one or more of the years 1936–39, is more representative than that precise quadrennium. Moreover the provision fixing the credit at 95 percent (not 100 percent) of average earnings is not justifiable save as a means for obtaining additional taxes.

All things considered, then, rapidly growing businesses, businesses with fluctuating earnings, businesses where the degree of risk is commonly great, businesses which have engaged in developing new processes and patents that are now becoming successful, businesses whose assets are now worth greatly in excess of cost, contractors on projects requiring several years to complete, and businesses in which personal service is a major factor are apt to find themselves at a disadvantage as compared to the well-established, steadily profitable enterprise.

RELIEF PROVISIONS

Congress and the Treasury sought to meet this state of affairs with relief provisions, which have expanded and contracted like an accordion. Originally conferring the broadest power on the Commissioner to adjust abnormalities in income or capital, these provisions were contracted in 1941 to

a series of specific cases in which relief might be granted.[11] All of these applied to abnormalities of income, either in the base period or in the taxable year. They gave the Commissioner no general power to adjust abnormalities in invested capital, and at the same time gave him limited authority to adjust abnormalities in base-period net income and incomplete power to adjust abnormalities in income subject to the tax. The 1942 law greatly broadened the Commissioner's powers to adjust abnormalities, in general by permitting the taxpayer to establish "a constructive average base period net income," a "fair and just amount representing normal earnings."[12] So broad and vague a standard is almost no standard at all. Probably Congress really meant that the Commissioner should designate a group of wise men who would determine, in the end, at what point the taxpayer's profits became excessive, in the light of the corporate history. Well-trained and competent men may be able to make such a determination, but they will be supermen if they are able to do it in a reasonably short time, without endless hearings, briefs, and records, and with fairness both to the Treasury and the taxpayer. For every business has its own peculiar problems, its cycle of profits and losses, and of development and decline. The basic reason that the excess-profits tax cannot work well is that in determining what are excessive profits it seeks to apply one of two rules to all kinds of corporations, with all sorts of capital structures, financial situations, risks, earnings, growth, and so on. The present relief provisions recognize the impossibility of applying the dual standard equitably and hence grant broad powers to adjust abnormalities. But if corporations generally should apply for relief, and surely many will, administration of the tax will become costly, uncertain, and cumbersome. The

[11] INT. REV. CODE §§ 722, 723; Magill, *op. cit.* note 10.
[12] § 222 of the 1942 Act, amending § 722, INT. REV. CODE.

history of the relief provisions alone indicates that the whole excess-profits tax philosophy needs reëxamination and fundamental revision. Special relief sections are decorative, but the statute itself ought to be fair enough so that they will truly apply to the special case, not the general one.

Section 215 of the 1942 law also inserts a new specific provision affording substantial relief to corporations whose credit is computed under the average-earnings method and which had low earnings in one or more years in the base period. This section provides that if excess-profits net income of any year in the base period is less than 75 percent of the average of the other years in the base period, the excess-profits net income of that year shall be considered to be 75 percent of the average for the other years. The provision is applied to the year which will benefit the taxpayer the most.

Revision of the Law

Nothwithstanding its inequities in regard to the corporation itself and to its stockholders, an excess-profits tax law will surely continue on the books during the war. A fundamental revision is possible, however; and it is also possible to consider the place of the tax in a more permanent fiscal structure after the war. The main condition to revision is determination by the Treasury to take the time and devote the energy to thorough study and analysis of results to date. The hearings before the Congressional committees in 1941 and 1942 contain a vast amount of data on the actual effect of the tax on particular corporations; and the Treasury files must contain much more. The Treasury now has an adequate legal and economic staff to go over all this material and to formulate intelligent conclusions well in advance of Congressional committee sessions. Great improvements can

be effected if competent experts are given the time to work them out.

Several major possibilities are suggested by experience to date. It seems advisable to continue the alternative credits, invested capital and average earnings, since this degree of flexibility eliminates a good many of the severe hardships a single standard would impose. The average-earnings credit should be made 100 percent of the earnings for the base period. The corporation should be given a choice as to the years to be employed in the base—perhaps any two of the years 1936–39. Such a provision would eliminate a good many cases which otherwise must be dealt with under the special relief provisions.

Something must be done to permit the determination of invested capital with greater certainty and with less expense. In fairness, statutory invested capital ought to conform as nearly as may be to the investment as shown by the corporation's balance sheets distributed to its stockholders. Obviously capital and surplus there shown may be inflated or deflated, but if the balance sheet has been prepared in accordance with recognized accounting rules, the figures shown are apt to be as fair a representation of the facts as the usually controversial tax figures. The excess-profits tax applies only to a minority of corporations. The bulk of the revenue probably comes from companies whose accounts and financial statements are regularly audited and certified by independent accountants; whose published reports are subjected, not only to standard accounting tests, but to the regulations of stock exchanges on which their securities are listed. The Treasury would therefore do well to consider whether invested capital might not be defined as that shown in the published corporate statements as of December 31, 1939 (or as of the end of last fiscal year prior to that date), adjusted for changes since that time. Probably most corpora-

tions would obtain a much larger invested capital under this method than by that currently in vogue. On the other hand, the method would usually provide a reasonably accurate statement of capital actually invested in the business. More important, the Treasury and the taxpayer would gain tremendously from the definiteness and noncontroversial character of the invested capital so determined. Finally, allowable rates of return on invested capital are low; corporations would not escape the tax completely by any means. At the least, the Treasury might well make some calculations to see how the method would work out and what rates must be adopted to assure needed revenue.

Again, since business risks vary and since capital normally requires more return in some enterprises than in others, the allowable rates of return ought not to be arbitrary, as at present, but should have some relation to the actualities of the particular case. If the last suggestion is adopted, keying invested capital to the corporate books of account, it would not be difficult to determine for any corporation its actual rate of return on the investment during a representative period. The invested-capital credit might then be computed at this rate, provided that it fell between maximum and minimum rates set in the law, as 6 to 15 percent. An arrangement of this sort would be much fairer, as well as more realistic.

Again the various adjustments should be carefully revised, so that corporations receive adequate allowances for necessary expenditures, whether or not these are deductions for income-tax purposes. The great criticism of the present law in this regard is its failure to allow a deduction for the corporate normal tax and surtax. If the income tax be regarded as a true tax, a charge on the corporation's earnings ranking ahead of stockholders and simple contract creditors, then it ought to be allowed as a deduction in computing

excess-profits net income. In this view the company has no excess profits until its business expenses, including taxes, are paid. The current failure to provide for the deduction of income taxes could be justified, however, on the theory that the Treasury has assumed the place of a stockholder of the corporation to the extent of about a forty percent interest; and, therefore, that its share of profits is no more a deduction for excess-profits tax purposes than the dividends paid to private shareholders. This latter theory has certainly not been an announced governmental policy. The deduction has probably been denied for purely revenue reasons. On the more orthodox analysis, the deduction should be allowed.

This conclusion assumes, however, the retention of the present system of corporate taxation. If stockholders should be given a credit for taxes paid by corporations, then the latter are really being paid at source on the stockholders' behalf, and would not be a proper deduction by the corporation against its excess-profits net income.

Some allowances may have to be made also for new construction and more liberal allowances for debt retirement. These are, of course, capital charges, but with taxes what they are, a good many corporations are hard put to it to finance them.

Finally, the brackets of the excess-profits tax itself should not be related to aggregate profits in dollars; but to the percentage of profits in excess of the basic credit.[13] The fact that a company has $1,000,000 "adjusted excess-profits net income" may mean, of course, that it has increased its earnings 10 percent over peacetime levels. The material factor for excess-profits tax purposes seems to be the percentage of increase, not the dollar amount.

These changes would greatly simplify the administration

[13] The 1942 law employs a single rate of 90 percent of adjusted excess-profits net income. The prior law contained bracket rates of 35 to 60 percent.

of the tax; they would increase its fairness and eliminate the necessity for special relief on a wholesale scale. They would reduce the revenue from the tax, but if intelligently carried out, they would make the tax bearable. The danger that the present tax will be destructive is real; enough hard cases have already been given to the Congressional committees to demonstrate that fact. The present law is too much a combination of harsh and rigid general provisions, coupled with numerous bits of generosity to particular businesses. The Treasury and Congress ought to undertake a complete revision, to put the equity into the provisions of general application and thereby to eliminate most of the need for special exemptions. So revised the tax could serve usefully during the war.

After this war, as after the last one, it would be wise to repeal the excess-profits tax as quickly as possible. The tax is designed "to take the profit out of war." Its prime function is to hold down corporate profits, its secondary function to produce revenue. The difficulties of equitable application are severe. The theory of the tax is sounder than it works out to be in actual practice. The ordinary income tax is much better developed, is fairer and far less complicated, and yields greatly more to the Treasury. Business will have a serious time after the war in making the readjustments to a peacetime and perhaps depressed economy. It would be well to free corporations from the excess-profits tax, as from other wartime regulations and to rely upon the income tax as the major impost on corporations. The excess-profits tax is not yet sufficiently well worked out to be relied upon as a regular source of revenue.

CHAPTER VI

FEDERAL TAXATION IN THE PRE-WAR DECADE

FEW LAWYERS would question that the past decade has constituted a distinct era in federal taxation, as it has in other fields of social and business endeavor.[1] The twenty years between the beginnings of the income tax in 1913 and 1932 had seen the great expansion of the federal tax system to meet the costs of World War I, followed by quite as dramatic tax reductions in the twenties. The twenties also witnessed in 1924 one of the comparatively few general revisions of the revenue acts; resulting in the establishment of the Board of Tax Appeals, the formulation of the elaborate reorganization and exchange provisions and of the subdivisions for the taxation to the grantor of the income of revocable and insurance trusts. The 1924 act also firmly established the policy of detailed and specific substantive provisions, as distinguished from more general statements of legislative intent, accompanied by authority to the Commissioner to fill in details by regulations. The estate tax declined to minor significance with the adoption of the 80 percent credit for state inheritance taxes; and the gift tax was invented and killed, all within two years.

The catastrophe of 1929, and the resulting federal deficits

[1] This chapter is an elaboration of an address delivered before the Association of the Bar of the City of New York, February 17, 1942. It was published in (1942) 42 COLUMBIA LAW REV. 356; reproduced by permission of the publishers.

in 1931 and 1932 set the stage for the adoption of new taxes and increases in rates of old ones—a policy continued practically without interruption through the succeeding decade. In 1932, the tax on a married man's net income of $5,000 was $100; it is now $746. The tax on a net income of $25,000 was $2,520; it is now $9,220. As would be expected, these increases in rates have been accompanied by increasingly severe substantive provisions, ranging from the general loophole-closing act of 1937 to the application of individual normal taxes to corporate dividends. The most notable new taxes have been the excess-profits tax on corporations; the gift tax on individuals; and the undistributed-profits tax on corporations, enacted in 1936 and finally repealed in 1939. The impact of the federal tax system upon the community may be indicated by the increase in total internal revenue collections from a little over one and one-half billions in 1932 to over thirteen billions in 1942.

In each year from 1932 through 1942 there has been at least one act affecting internal revenue. In recent years, there have been two and sometimes three. To analyze and interpret each of these laws in any detail would be a stupendous task, requiring several volumes.[2] Long law-review articles and notes have also been written upon the implications of various major decisions of the Supreme Court during the period, such as the *Sanford*,[3] the *Hallock*,[4] the *Clifford*,[5] the

[2] See, *e.g.*, MONTGOMERY, FEDERAL TAX HANDBOOK (1940–41); MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS (1941–42); MONTGOMERY, EXCESS PROFITS AND OTHER FEDERAL TAXES ON CORPORATIONS (1941–42); PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934–35).

[3] Estate of Sanford v. Commissioner, 308 U. S. 39 (1939); see Magill, *The Federal Gift Tax* (1940) 40 COLUMBIA LAW REV. 773; and see Wales, *"Indian Gifts"* (1939) 34 ILL. L. REV. 119. See Warren, *Correlation of Gift and Estate Taxes* (1941) 55 HARV. L. REV. 1.

[4] Helvering v. Hallock, 309 U. S. 106 (1940); 49 YALE L. J. 1118.

[5] Helvering v. Clifford, 309 U. S. 331 (1940); see Pavenstedt, *The Broadened Scope of Section 22(a)* (1941) 51 YALE L. J. 213; Magill, *The Federal Income Tax on the Family* (1941) 20 TEXAS L. REV. 150.

Douglas,[6] and the *Horst*[7] cases, not to mention innumerable lower court and Board decisions. The present summary will not compete with those longer and more adequate discussions. The main purpose of this chapter will be to consider the major trends now discernible in statutes and decisions; and to advance a few suggestions as to future directions. Thus, I shall attempt no section by section legal interpretation of the excess-profits tax law in whole or in part; but I shall advance a few tentative conclusions as to its probable utility and consequences in our tax system. It has seemed convenient, mainly for purposes of clarity, to separate the discussion of the statutory history of the period from the judicial history; to a considerable degree, the Supreme Court was construing the legislation of the twenties, not of the thirties.

Statutory History

The last ten years have seen the addition and repeal of many pages in the statute books, but the fundamental policies have remained curiously static. The great changes have not been in the general philosophy of the revenue acts, but primarily in the addition of new taxes. The core of the structure has remained the same. Additions have been stuck on here and there, which do not fit very well, for the architects had differing ideas. The roof has been pretty completely patched, so that it would not leak so much, and fresh paint has been put on occasionally; but certainly the old house built in the twenties is still recognizable and its foundations are unchanged. Thus, there have been no such changes in the income tax even as the reorganization provisions or the

[6] Douglas v. Willcuts, 296 U. S. 1 (1935); see Paul, *Five Years with Douglas v. Willcuts* (1939) 53 HARV. L. REV. 1.

[7] Helvering v. Horst, 311 U. S. 112 (1940); Shattuck, *Taxation of Deflected Income* (1941) 13 ROCKY MT. L. REV. 220; see also (1941) 41 COLUMBIA LAW REV. 340; (1941) 54 HARV. L. REV. 1405.

trust provisions added in 1924. Typical changes have been the addition of more rigorous sections as to personal holding companies, foreign and domestic;[8] alterations in the basis provisions;[9] a section on the accrual of income to a decedent[10]—important to the persons affected, but not of much general interest.

ADMINISTRATIVE IMPROVEMENTS

The comparative unproductiveness of the Congress and the Treasury in the formulation and enactment of broad general improvements that must be studied for months and years before adoption is perhaps the most striking feature of the past decade. The major changes have been essentially administrative in character. In 1939, the revenue laws, without any intention of material alteration, were consolidated into a code, which was then enacted into law. Since 1939, new revenue enactments have been in the form of amendments to the Code. The resulting convenience to lawyers and taxpayers is a major gain, even though the wording and effect of the various sections is unchanged. The Treasury has recently, after four years of preparation, published a proposed internal revenue administrative code, seeking to modernize and clarify the existing statutory provisions, many of which date back to the post-civil-war era. The work has been carefully done; and in due course this code will probably be enacted. Two other important administrative changes are sections 3760 and 3801 of the Internal Revenue Code, originally enacted in 1938. The first authorizes the Commissioner to issue rulings and final closing agreements with respect to proposed future transactions, not merely with respect to past situations. Thus a taxpayer may submit

[8] See INT. REV. CODE §§ 102, 500–511.
[9] *Id.* §§ 113(a) (13), (15), (17), (18), (19).
[10] *Id.* § 42; revised by § 134 of the 1942 Act.

to the Commissioner a proposed contract, trust, or reorganization agreement for a ruling as to its tax consequences. If the ruling be unfavorable he need not carry out his original intention; nor does he need to proceed with the proposed transaction as outlined to the Commissioner. However, if the ruling is satisfactory he may then conclude a binding agreement with the Commissioner that the transaction will be taxable as the ruling provides. In this way, a good deal of the tax uncertainties surrounding important prospective arrangements can be eliminated. The section has been much used, and on the whole reasonably administered.

The other section is designed to lift the bar of the statute of limitations in stated situations when either the Commissioner or the taxpayer maintains as to some item of income or deduction a position inconsistent with that asserted in a prior year. The inconsistency may relate to the person who is to report or deduct the item, the year in which the item is to be reported, or the basis of property. The purpose of the section is to prevent double taxation of the same item of income, double deductions, or inequitable avoidance of tax.[11] The section does not reopen the return for the past year for all purposes; but only for the purpose of adjusting the inconsistency. The section, though complicated, by no means covers all possible cases of inequities of this character. It is a good start; it seems to have worked satisfactorily; and as experience develops, it ought to be extended further.

TAXATION OF STATE OFFICIALS AND BONDS

Among other significant changes was the enactment of the public-salary taxing act, to bring state officials within the ambit of federal income taxation, and vice versa. The

[11] See Maguire, Surrey, Traynor, *Section 820 of the Revenue Act of 1938* (1939) 48 YALE L. J. 509, 719; Kent, *Mitigation of the Statute of Limitations in Federal Tax Cases* (1939) 27 CALIF. L. REV. 109; (1939) 39 COLUMBIA LAW REV. 460.

way was opened for the statute by *Helvering v. Gerhardt,*[12] and *Graves v. O'Keefe,*[13] indicating that such a provision would be constitutional. Although recommendations were made from time to time for the elimination of the tax exemption accorded to interest on state and municipal bonds, nothing was actually done. Congress did, however, eliminate exemption with respect to obligations of the United States and its agencies issued after March 1, 1941.[14] In war times there is little excuse for preserving one class of income in a bomb-proof shelter, while all other classes are being very heavily taxed. The exemption has long been a major form of tax avoidance, and this is the best possible time to eliminate it.

CHANGES AFFECTING CORPORATIONS

The consolidated-returns provisions, recognized as necessary to a businesslike determination of the income of an affiliated group, were eliminated in 1936 except as to railroads,[15] but when the excess-profits tax came in, consolidated returns were permitted as to it.[16] In 1942 the privilege of filing consolidated income tax returns was extended to all classes of corporations, presumably because of present business uncertainties and the high tax rates. The reorganization provisions have been progressively tightened, and some

[12] 304 U. S. 405 (1938), holding an engineer employed by the Port of New York Authority subject to federal income tax on his salary.

[13] 306 U. S. 466 (1939), holding an attorney employed by the federal Home Owners Loan Corp. subject to the New York State income tax; and expressly overruling Collector v. Day, 11 Wall. 113 (U. S. 1870) and N. Y. *ex rel.* Rogers v. Graves, 299 U. S. 401 (1936).

[14] Pub. Law No. 7, 77th Cong., 1st Sess. (Feb. 19, 1941) § 4; see also Gray, *Derivative Tax Immunity and the Income from State Bonds* (1941) 41 Columbia Law Rev. 1357.

[15] See Int. Rev. Code § 141.

[16] *Id.* § 730, as amended.

forms of tax-free reorganization eliminated,[17] a process in which the Supreme Court assisted, not always too intelligently.[18] Personal holding companies, foreign and domestic, have been so burdened with additional taxes and restrictions,[19] that no one would advocate the formation of one nowadays. Indeed lawyers have been spending much time, in recent years, trying to evolve satisfactory methods of getting rid of existing personal holding corporations. Another item in the catalog of amendments adversely affecting corporations and investments in corporations was the elimination in 1936 of the credit against the normal tax theretofore granted individuals for dividends received from corporations. In 1935, the previous full deduction allowed to one domestic corporation for dividends received from another—intended to prevent the multiplication of taxes on corporate income received from a subsidiary—was reduced to 90 percent.[20] In 1936, it became 85 percent,[21] at which figure the credit has since remained.[22] The effect of these changes is to impose an additional tax of about 6 percent on income derived by a corporation through its subsidiary.

The doing of business in corporate form has become quite uneconomical, in view of the high rates of the various forms

[17] The former § 112(g) was deleted in 1934; under it, a stockholder of Corporation *A* realized no gain on the receipt of stock of *A's* newly organized subsidiary *B,* in which *A* had segregated some of its assets. *Cf.* the changes in the basis provisions § 113(a) (7) and (8), making them more broadly applicable in carrying over the transferor's basis to the transferee. See Fahey, *The Income Tax Definition of "Reorganization"* (1939) 39 COLUMBIA LAW REV. 933.

[18] See, *e.g.,* U. S. v. Hendler, 303 U. S. 564 (1938), holding an assumption of indebtedness to be "boot" in a reorganization, a decision which required prompt statutory correction [see §§ 112(g), 112(b) (5), 112(k), 113(a) (b)].

[19] See note 8 *supra.* See Paul, *The Background of the Revenue Act of 1937* (1937) 5 U. OF CHI. L. REV. 41, 49, 58.

[20] Rev. Act of 1935, § 102(h), amending Rev. Act of 1934, § 23(p).

[21] Rev. Act of 1936, § 26(b).

[22] INT. REV. CODE § 26(b).

of taxes imposed on corporations, as well as the several restrictive amendments referred to. It is often much cheaper today for a partnership to conduct an enterprise than for a corporation to do so. The premium which must now be paid for the insurance of corporate limited liability is very high; and a lawyer should always explore the possibilities of some other type of organization. Again, since interest is deductible, whereas dividends are not, there is a strong tax incentive toward the use of notes, debentures, or bonds in financing, rather than preferred stock. Few would argue that the tax laws should particularly encourage debt rather than equity financing. Some day the whole system of corporate taxation must be thoroughly overhauled, not by the addition or subtraction of a few gadgets here and there; but by a reorientation of the basic theory of the tax.[23] The ability to pay that everyone glibly talks about is the ability to pay of the individuals who own the income-producing assets or business. A proper tax system will be so constituted that the taxes on corporate income are, at least for the most part, determined with reference to the total incomes of those entitled to the corporate earnings.

CHANGES AFFECTING INDIVIDUALS

Significant amendments affecting individuals, other than the enactment of new taxes and increases in the burdens of old ones, were not numerous. In 1934, the phrase "during the taxable year" was eliminated from Section 166, dealing with revocable trusts, so that the income of trusts revocable upon notice of a year and a day became taxable to the settlor. This, it seems, should have been the result without a statutory change, but the decisions were generally otherwise.[24]

[23] See, *e.g.*, the excellent report of the NATIONAL TAX ASSOCIATION, *Committee on Federal Taxation of Corporations,* PROCEEDINGS 1939, p. 534; James, *Irascible Comments on the Revenue Laws* (1941) 9 U. OF CHI. L. REV. 58, 64.

[24] See MAGILL, TAXABLE INCOME (1936) 279 *et seq.*

The same type of problem is presented, however, by the more difficult case of a trust, revocable upon some contingency, such as the death or marriage of a beneficiary. Cases of this character should, it seems, turn upon the degree of control which the settlor has in fact retained. Now that we know that the settlor is taxable on the income of a short term trust for a member of the intimate family group,[25] we may surmise that he will be taxable upon the income of a trust for the benefit of members of the immediate family, if his power to revoke arises after two or three years' notice,[26] or upon the death of an aged relative,[27] or upon the marriage of an eligible daughter. On the other hand, a power to revoke upon the death of a daughter in good health gives no real control to the settlor; and in the absence of other *Clifford* case factors discussed below, should not render the settlor taxable.

The capital-gain provisions, always an uneasy part of the statute, were twice revamped, in 1934 and 1938. The present method of taxation[28] gives long-term gains the benefit of a maximum tax rate of 25 percent, and allows the deduction of capital losses from capital gains, or from ordinary income up to $1,000. Any excess may be carried over for five years, and similarly deducted. The problem of equitable taxation of this kind of income has not yet been solved; and the argument whether capital gains should be taxed at all still goes on.

Provision was also made in 1934 for the taxation as income to a decedent, even one who had been taxed on a cash basis, of items which had accrued during the period just

[25] *Cf.* Helvering v. Clifford, 309 U. S. 331 (1940), discussed *infra* p. 187.

[26] *Cf.* Helvering v. Elias, 122 F.(2d) 171 (C. C. A. 2d, 1941), where the power to revoke arose 6½ years after the creation of the trust.

[27] But *cf.* the pre-Clifford decision of Corning v. Commissioner, 104 F.(2d) 329 (C. C. A. 6th, 1939).

[28] Contained in INT. REV. CODE § 117, as amended by § 150, Rev. Act of 1942.

before his death.[29] The amendment was aimed at cases in which income earned by the decedent and paid after his death had not been subject to inclusion in an income-tax return at all.[30] The Supreme Court in 1941 held[31] that fees only partially earned before death in amounts not fixed until later nevertheless "accrued" in part before death for this purpose. The decision was a forecast of a too-extensive application of the section in other situations. Suppose a corporate officer dies at a time when he is entitled to receive a pension for his life, with a right in his widow to receive an annuity for a period of years after his death. Is anything to be included on this account in his income-tax return for the period ended with his death? The statute presumably meant that items of income which can be regarded as earned before death should be taxed as income. Granted that the pension rights of the decedent and widow can be valued, the prospective payments to each are income when received,[32] not the decedent's income for the period before his death. It would be particularly inequitable to tax to the decedent as income the large sum representing the computed value of payments to be made for years to come. Hence the 1942 act added a new section 126 to the Code, providing that amounts subsequently received by the decedent's estate or his beneficiaries shall be treated as income of the same nature and to the same extent as would have been the case had the decedent survived and received such amounts. The

[29] *Id.* § 42.

[30] The right to receive the amounts had been reported for estate-tax purposes; hence the subsequent receipts were not regarded as income, except as they exceeded the estimated value at death. Nichols v. U. S., 64 Ct. Cl. 241, *cert. denied,* 277 U. S. 584 (1928); *cf.* Bull v. U. S., 295 U. S. 247 (1935).

[31] Helvering v. Estate of Enright, 312 U. S. 636 (1941). *Cf.* Parlin, *Accruals to Date of Death* (1939) 87 U. of Pa. L. Rev. 295.

[32] As to the computation of the amount of taxable income, see Int. Rev. Code § 22(b) (2).

amendments, lengthy and specific, ought to relieve the difficulties presaged by the *Enright* case.

NEW TAXES AND RATE CHANGES

Although there was a flood-tide of particular excises in 1932 as a substitute for a general sales tax then proposed by the Ways and Means Committee, these concern lawyers comparatively little. The gift tax, resurrected in the same year, though not a large revenue producer, provides a great many legal problems.[33] Every case of an *inter vivos* family settlement has gift-tax connotations.[34] The statute is unique among modern revenue laws in containing practically no specifications of the transfers which are deemed to be gifts and therefore taxable. We must work out what are taxable transactions from the *Sanford* case,[35] and to some degree from the *Hallock* case,[36] both of which will be considered later.

The rates of the gift tax have been maintained at a numerical ratio of three fourths of the corresponding estate tax rates. Thus there is a strong fiscal inducement in favor of gifts during life rather than bequests at death. This sanction acquires additional force from the existence of a special exemption of $3,000 per year per person for outright gifts (other than gifts of future interest in property).[37] In addition, there is a cumulative over-all exemption of $30,000.[38] Thus in the case of an aggregation of property of any size, it is possible to calculate exactly what is the most economical mode of disposition.[39] Generally, it will involve the trans-

[33] The present provisions appear in INT. REV. CODE §§ 1000–1031.

[34] A discussion of some of these problems appears in Chapter III.

[35] 308 U. S. 39 (1939). [36] 309 U. S. 106 (1940).

[37] INT. REV. CODE § 1003(b) (2) (1939), as amended by § 454, Rev. Act. of 1942.

[38] *Id.* § 1004(a) (1), as amended by § 455, Rev. Act of 1942.

[39] See, *e.g.*, MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS (1941–42) 671.

fer of the greater part, but not all, of the property during life, and the remainder at death. There is at present no statutory correlation between the gift tax and the estate tax, other than provision for credits against the estate tax, for gift taxes paid.[40] Each has its own exemptions.

The excess-profits tax was the other major impost during the period, arriving in 1940, quickly amended in 1941 and 1942.[41] At first blush all would agree that in times of national emergency there is no place for excess profits; they should flow to the public, not the corporate treasury. But to determine what are the excess profits of a corporation has proved to be an individualistic matter; it is almost impossible to formulate a test which will operate both justly and precisely.[42] The law now embodies two yardsticks, either available to the corporation at its option. Under the one, excess profits are profits in excess of 95 percent of average earnings for 1936 to 1939 inclusive.[43] Under the other, excess profits are profits in excess of 8 percent of the first $5 millions, 7 percent of the next $5 millions, 6 percent of the next $190 millions, and 5 percent of the invested capital over $200 millions.[44] There are many adjustments largely adopted to take care of special cases brought to the attention of the financial committees of the House and Senate.[45] Difficulties of more general occurrence, such as the accurate determination of invested capital of a corporation which has gone through reorganizations in earlier years; or an excessive tax today due in large part to excessive depreciation allowed in the twenties when tax rates were much lower, are not cared for.

[40] INT. REV. CODE § 813(a) (1939). See Warren, *loc. cit. supra* note 3.

[41] *Id.* § 710–752.

[42] See Magill, *Relief from Excess Profits Tax* (1941) 89 U. OF PA. L. REV. 843.

[43] INT. REV. CODE § 713 (1939), as amended.

[44] *Id.* § 714, as amended by § 217, Rev. Act of 1942.

[45] See, *e.g., id.* §§ 721, 722 and 723, as amended by §§ 221 and 222 of the Rev. Act of 1942.

Finally, this form of tax takes no account of the fact that many stockholders, who will bear the tax in the form of reduced dividends, bought in at prices on which pre-1940 dividends gave only a moderate return. There is a good deal of inequity to them in compelling them to bear a tax which has no relation to anything for which they are responsible. One by-product of this line of reasoning is that the excess-profits tax would be much more inequitable if it were based exclusively on invested capital.

These are only the highlights of the statutory changes. I have not mentioned the steep increases in rates and the lowering of exemptions of the major taxes, since these present legal problems only indirectly. But I should like to point to some of the major statutory tasks which remain to be done. The reorganization and exchange provisions ought to be completely overhauled, modernized, and simplified. They were originally prepared in the twenties with the basic purpose of facilitating corporate readjustments. They have been the subject of numerous legislative and judicial alterations in the thirties, all based on the theory that corporate readjustments should not be facilitated, but zealously watched to prevent tax avoidance. The sections are unduly technical and cumbersome, and a trap for the unwary. The Treasury and Congress should now decide what the policy is to be; draw up a much simpler statement of it; and then avoid the inconsistency of advocating a position before the courts, as in the *Hendler* case,[46] which everyone knows is bad policy, whatever its technical merits.

Litigation would be saved if the gift- and estate-tax sections were correlated into a single tax upon the transfer of property. There is no real need, to say the least, for encouraging controversy as to whether a particular transfer should be taxed both during life and after death; nor is there any

[46] See note 18 *supra*.

need for a double set of rates and exemptions, or for the present confusion as to the applicability of the gift tax. Probably most experts, other than the draftsmen who would have to make it, would agree upon the technical desirability of such a correlation. The objections to it are largely practical: the likelihood that it would form the basis for a further decrease in exemptions and an increase in rates, and thus a further diminution in the amount of property one can pass on to one's widow or children or others. These are cogent reasons for more careful examination of the social and economic consequences of taxation than they seem to have received. A proper correlation would also involve a simplification of the estate-tax provisions, as well as a determination of the policy to be followed in those situations where a man is taxed on the income of property on the theory that it is his, and on a gift of it on the theory that he has transferred it to someone else.

An administrative code, such as that presently proposed by the Treasury, should be adopted. The code should, however, straighten out the tangle of jurisdiction in federal courts and the new Tax Court of the United States, the former Board of Tax Appeals. A good start would be to make the Board a court in more than merely name, with jurisdiction over refund as well as deficiency cases. If this were done, the institution of tax cases in other federal courts would probably disappear.

Finally, there is a real opportunity to revise and simplify the whole structure of tax legislation. The Supreme Court has recently been astute in working out the specific application of what the Court considered to be the general statutory policy of Section 22. There is no reason to suppose that the Court would not perform the same function in other instances where a general policy was stated. Thirty years of experience with the income tax ought to be enough to

enable basic policies to be formulated. The task is not an easy one, but a competent statutory restatement of the more important federal tax laws, if undertaken along these lines, ought to make the law more intelligible, and reduce litigation as well.

Judicial History

An enumeration of the federal tax decisions of the Supreme Court during the past decade gives striking evidence of the variety, as well as the importance, of the major doctrines which have been developed. To understand and apply the gift tax to present-day transactions requires a careful analysis of the *Sanford*[47] decision. The *Hallock* case[48] conditions a good part of the estate-tax field; and there are several other decisions, like the *Wells* case,[49] that instruct us how to make property settlements today. The income tax has had a wide range of development at the hands of the Court, reaching from the constitutional questions involved in the *Gerhardt* case[50] to the deduction problem of the *Higgins* decision[51] last term. It is difficult in a brief discussion of the subject to be at once intelligible, concise and thorough. In the following pages, attention will have to be directed principally to trends and topics, rather than to particular cases; and more attention will be given to recent decisions than earlier ones.

THE GIFT TAX

The gift tax having been held constitutional,[52] the next question was as to its scope. Suppose that a donor transfers part but not all of the bundle of rights constituting owner-

[47] 308 U. S. 39 (1939). [48] 309 U. S. 106 (1940).
[49] U. S. v. Wells, 283 U. S. 102 (1931).
[50] 304 U. S. 405 (1938).
[51] Higgins v. Commissioner, 312 U. S. 212 (1941).
[52] Bromley v. McCaughn, 280 U. S. 124 (1929).

ship of property. For example, he parts with title irrevocably, but preserves a power to alter beneficiaries. Or he causes property for which he has paid to be transferred to himself and his wife as joint tenants or tenants by the entirety. Or he transfers either a life estate or a reversion, and retains the remaining interest.

Estate of Sanford v. Commissioner[53] involved the first situation. Sanford had created a trust for named beneficiaries in 1913, reserving powers to revoke or modify. In 1919, he surrendered the power to revoke, but reserved the power to modify, except that he might not secure principal nor income for himself. In August, 1924, during the life of the first gift tax, he relinquished this latter power. Years later, following the decision in *Hesslein v. Hoey,*[54] the Commissioner ruled that the gift was not complete until the 1924 relinquishment occurred, and therefore determined a tax. The Circuit Court of Appeals[55] and the Supreme Court sustained the tax. The Supreme Court relied largely upon estate tax cases, holding similar transfers in trust includable within the gross estate. The Court stated that the estate tax and gift tax are *in pari materia;* and added:

> We think, as was pointed out in the Guggenheim Case [288 U. S. 280], *supra,* 285, that the gift tax statute does not contemplate two taxes upon gifts not made in contemplation of death, one upon the gift when a trust is created or when the power of revocation, if any, is relinquished and another on the transfer of the same property at death because the gift previously made was incomplete.[56]

The Court also referred to the secondary liability of the donee for the tax, impossible of conclusive assertion if the donee is uncertain; and to the confused administrative practice.

[53] 308 U. S. 39 (1939).
[54] 91 F.(2d) 954 (C. C. A. 2d, 1937).
[55] 103 F.(2d) 81 (C. C. A. 3d, 1939).
[56] 308 U. S. at 45.

All would agree on the desirability of construing the gift tax, the estate tax and the income tax as a harmonious whole. On the other hand, it has seemed reasonably clear that the present statutes not only do not bring about this result, but to an important degree specifically assert the contrary theory. The creation of a joint tenancy or a tenancy by the entirety may, it seems, involve a taxable gift, for valuable interests may have been bestowed upon the other tenant which are thereafter entirely beyond the control of the donor.[57] Presumably the credit for the gift tax against the estate tax[58] was intended to meet such situations. Again, in the *Hallock* type of situation (the creation of a trust with a life estate and remainder in others, but with a possible reversion to the settlor) the settlor has created beyond recall valuable interests in others. The fact that part of the value of the property may be included in his gross estate does not exclude the possibility of a present gift. A better test would seem to be: Has the transferor completely relinquished *inter vivos* ownership and control of interests in the property having an ascertainable value? If he has, a gift tax may be asserted, even though the estate tax may also be applicable.

Thus the *Sanford* decision, though no doubt intended to introduce more order into the relations of the three major taxes, raises questions more serious than those it settles. It established clearly, however, that one can always avoid a gift tax upon the creation of a trust by reserving to the settlor a power to modify; the estate tax will then be applicable in due course.

[57] Lilly v. Smith, 96 F.(2d) 341 (C. C. A. 7th, 1938), *cert. denied,* 305 U. S. 604 (1939), (1938) 17 N. C. L. REV. 71; Commissioner v. Hart, 106 F.(2d) 269 (C. C. A. 3d, 1939); Commissioner v. Logan, 109 F.(2d) 1014 (C. C. A. 3d, 1940). See also Magill, *The Federal Gift Tax* (1940) 40 COLUMBIA LAW REV. 773, 785; (1938) 37 MICH. L. REV. 340; (1938) 47 YALE L. J. 1213.

[58] INT. REV. CODE § 813.

THE ESTATE TAX

The most significant estate tax-decision of the decade was *Helvering v. Hallock.*[59] I shall therefore focus attention upon it, giving mention only in passing to other important decisions. *Heiner v. Donnan*[60] established the invalidity of a conclusive presumption that transfers within two years of death have been made in contemplation of death. The second gift tax was a direct consequence. *Helvering v. Grinnell*[61] held that property passing under the will of the donor of a power of appointment, where the appointees had renounced their rights under the will of the donee who exercised the power in their favor, was not subject to tax in the estate of the donee. This particular loophole has now been plugged. Property passing by virtue of the non-exercise of a power, as well as by its exercise, is subject to tax since 1942 in the donee's estate, unless the power may be exercised in favor only of a carefully limited group: spouses of the donor or donee; descendants of the donor or donee or of their spouses (but not the donee); spouses of such descendants; and religious, charitable and educational institutions and the like.[62]

The application of the estate tax to a case where property transferred in trust is subject to a power to revoke in the decedent and another, even a beneficiary, has been upheld.[63] The regulations defining what insurance proceeds are to be included in the gross estate were twice changed. At present, either the payment of premiums by the decedent or the retention of incidents of ownership will subject his estate to tax.[64]

The opinion in the *Hallock* case dealt with five different

[59] 309 U. S. 106 (1940). [60] 285 U. S. 312 (1932). [61] 294 U. S. 153 (1935).

[62] See § 403, Rev. Act of 1942. For a criticism of the earlier laws, see Griswold, *Powers of Appointment and the Federal Estate Tax* (1939) 52 Harv. L. Rev. 929, and reply by Leach, *id.* at 961; (1941) 41 Columbia Law Rev. 149.

[63] Helvering v. City Bank Farmers Trust Co., 296 U. S. 85 (1935).

[64] U. S. Treas. Reg. 80, Art. 25–27. The 1942 law confirms this interpretation in § 404.

trusts, containing the one common feature of provisions, differing in exact terms, whereby if the settlor survived the life beneficiary, he was to take the property. Thus although the case is sometimes spoken of as involving a possibility of reverter, the decedent's interest was more substantial. In each case, the settlor died before the life beneficiary; and the question was whether any part of the corpus should be included in his estate. The decision for the Commissioner is devoted primarily to a criticism of the "unwitty diversities of the law of property derived from medieval concepts" and the overruling of *Helvering v. St. Louis Trust Co.*[65] and *Becker v. St. Louis Trust Co.*[66] decided only five years previously. The opinion does not clearly specify the exact scope of the decision; it does not even explicitly indicate how much of the corpus is to be included in the gross estate. But taken with the decisions in the courts below it appears to hold that the value of the life estates is to be deducted. This result is reasonable, first, because the life interests are vested and are unaffected by the death of the settlor; and second, because a gift tax would seem to be due with respect to them. Nevertheless, it is not clear yet that the Treasury will finally settle on this basis.[67]

The best statement of the approved doctrine is a quotation from the *Klein* case:

> It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed.[68]

This philosophy, as applied to cases like the *Hallock* trusts, is sound. To the extent of the remainders, the transfers do in fact take effect in possession or enjoyment at or after death. As a practical matter, however, trusts with provisions of this

[65] 296 U. S. 39 (1935). [66] 296 U. S. 48 (1935).

[67] *Cf.* Art. 17 of U. S. Treas. Reg. 80, as amended by T.D. 5008; C. B. 1940–2, 286.

[68] 283 U. S. 231, 234 (1931).

character will give difficulties for some years to come. For example, does the *Sanford* decision mean that a *Hallock* type trust is not subject to the gift tax at all? If it is not, then presumably the entire value of the corpus should be included in the gross estate, contrary to the present Treasury regulations.

INCOME TAX

There are at least 30 decisions of the Supreme Court in the income tax field during the past decade which are worth the careful study of any lawyer dealing regularly with these problems.[69] This discussion is to be limited to seven, chosen because they have great present-day and future significance in different subdivisions of the law.

[69] a. *Constitutional questions:* Helvering v. Gerhardt, 304 U. S. 405 (1938); Graves v. New York *ex rel.* O'Keefe, 306 U. S. 466 (1939); Liggett & Myers Tobacco Co. v. U. S., 299 U. S. 383 (1937); U. S. v. Stewart, 311 U. S. 60 (1940).

b. *Corporate distributions:* Koshland v. Helvering, 298 U. S. 441 (1936) (nature of a stock dividend); Gregory v. Helvering, 293 U. S. 465 (1935) (business purposes in reorganizations); Groman v. Commissioner, 302 U. S. 82 (1937) (transfers in reorganization to a subsidiary); Helvering v. Bashford, 302 U. S. 454 (1938) (similar); Helvering v. National Grocery Co., 304 U. S. 282 (1938) (Section 102); Palmer v. Commissioner, 302 U. S. 63 (1937) (stock rights).

c. *Concept of Income:* North Am. Oil Consolidated v. Burnet, 286 U. S. 417 (1932) (income in dispute); Brown v. Helvering, 291 U. S. 193 (1934) (accrual of returned commissions); Bull v. United States, 295 U. S. 247 (1935) (accrual of decedent's earnings); Helvering v. Estate of Enright, 312 U. S. 636 (1941) (same); Helvering v. Bruun, 309 U. S. 461 (1940) (improvements on leased land); General Utilities Co. v. Helvering, 296 U. S. 200 (1935) (dividend in kind); Helvering v. Midland Life Ins. Co., 300 U. S. 216 (1937) (mortgage foreclosure); Helvering v. Horst, 311 U. S. 112 (1940) (assigned interest coupons); Helvering v. Eubank, 311 U. S. 122 (1940) (assigned commissions).

d. *Trusts and annuities:* Harrison v. Schaffner, 312 U. S. 579 (1941) (assigned trust income); Blair v. Commissioner, 300 U. S. 5 (1937) (same); Helvering v. Clifford, 309 U. S. 331 (1940) (short term trust); Burnet v. Wells, 289 U. S. 670 (1933) (insurance trust); Douglas v. Willcuts, 296 U. S. 1 (1935) (alimony trust); Helvering v. Fuller, 310 U. S. 69 (1940) (same). Helvering v. Schweitzer, 296 U. S. 551 (1935) (support of minors); Helvering v. Butterworth, 290 U. S. 365 (1933) (annuity); Helvering v. Reynolds, 313 U. S. 428 (1941) (basis).

e. *Deductions, etc.:* Higgins v. Commissioner, 312 U. S. 212 (1941) (investment expenses); Burnet v. Huff, 288 U. S. 156 (1933) (embezzlement); Spring City Foundry Co. v. Commissioner, 292 U. S. 182 (1934) (bad debts); Morrissey v. Commissioner, 296 U. S. 344 (1935) (business trust).

a. *Gregory v. Helvering*[70] and *Groman v. Commissioner*.[71] The requirement of a "business purpose" to insure the validity of a transaction for tax purposes has been a part of the law at least since *Gregory v. Helvering*. That case established the proposition, meritorious enough to a layman but not so acceptable to a technician, that compliance with the exact terms of the reorganization and exchange provisions is not alone enough. Nor, approaching a transaction from the other side, is it necessary for the Treasury to establish fraud to upset a technically letter-perfect reorganization. There is an intermediate twilight zone. Even though the transaction was meticulously carried out, and all facts were truly disclosed, if the transaction had no reason other than a saving in federal taxes, it may in substance be treated as a nullity. Oftentimes this particular test either has no relevance or is easy to meet. Sometimes it causes a good deal of trouble where, for example, the transaction obviously has tax considerations among its motivating factors, but there are other reasons as well. In general, such a transaction should be taxed as it actually occurred. In any event, considerations of prompt administration and of business practicability require that, in the absence of fraud, transactions should generally be taxed according to the form they actually took. At the same time, the lawyer will certainly advise against transactions which have no sensible motive other than too acute tax consciousness.

Groman v. Commissioner did much more damage to the utility of the reorganization provisions. Although the case does not specifically so hold,[72] it has been widely interpreted as meaning that if Corporation *A* agrees with Corporation *B*

[70] 293 U. S. 465 (1935).

[71] 302 U. S. 82 (1937).

[72] Petitioner and other stockholders of *I* corporation agreed with *G* corporation to transfer their shares to a newly organized corporation *S*, all of whose common *G* would own, in exchange for *G* preferred, *S* preferred and cash. The transaction was carried out, and *S* dissolved *I*. *Held:* *G* was not a party to the reorganization, and the value of its preferred constitutes "boot."

or its stockholders to acquire *B's* assets or stock in exchange for *A's* voting stock, but if the actual transfer is made at *A's* request to *A's* subsidiary *S,* then the exchange by *B* or its shareholders is taxable. *A* is not technically a party to the reorganization, and its stock is treated as cash in the hands of the recipients. With its usual genius for advancing its lines after an initial success, the Treasury has asserted a tax against *B's* shareholders even though the original exchange of *A* stock for *B* stock was directly with *A,* and only months later did *A* transfer the *B* stock to *S,* and dissolve *B*. If mergers and like transactions are to be allowed tax-free, as long as no money passes, these reorganizations should be given the same treatment, for the *B* stockholders have not yet realized upon their investment, but their possible profits or losses are still locked in the business. The Supreme Court has urged that there is a lack of continuity of interest. It is clear, however, that if the exchange was of *A* voting stock for *B* stock, and *A* retained *B* as a subsidiary, the reorganization would be tax-free, though here also the *B* stockholder exchanges a direct control over the *B* company for an indirect interest, usually a small minority interest, in *A* holding company which in turn owns the *B* stock. There is a curious lack of realism in the reasoning of the *Groman* decision and its extension to these new areas. The difficulty of reasoning from unacceptable premises, coupled with the uncertainties as to when two transactions separated in time will be regarded as steps in a single plan, when as distinct and independent,[73] has made the reorganization provisions quite unusable, except in the simplest cases. If, as seems likely, we face an era of corporate reorganizations after the war, the Treasury and Congress should certainly act to end present uncertainties, first by the adoption of some clear philosophy on the subject of corporate readjustments, and, second, by

[73] See PAUL, SELECTED STUDIES IN FEDERAL TAXATION (2d series) 200 (1938).

a complete revision of the present unduly abstruse, technical, and largely unworkable provisions.

b. *Helvering v. Horst*[74] and *Helvering v. Eubank.*[75] The Supreme Court has dealt with a dozen cases within the decade which can be classified as involving problems of accounting for income. Some dealt with the time of realization of income,[76] some with the kind of benefit,[77] which, even in the absence of a receipt of money or property, will be taxed as income. Most of these cases have a continuing significance, but only two will be discussed here at any length.

Since 1930 it had been established that assignments of income to be earned by the assignor in the future were generally taxable to the assignor.[78] One basic reason was that the assignor controlled the earning of the income and hence its continued receipt by the assignee. What would be the result of an assignment if this control feature were missing, as in the case of transfer and delivery of interest coupons cut from a bond, and payable in the future; or of an assignment of renewal commissions on life insurance already written? Some lower courts had held the assignee taxable in such situation,[79] but when the issue came squarely before the Supreme Court in 1940, it held the assignor taxable in both cases.

In the *Horst* case, involving interest coupons, assigned by a father to his adult son, the kernel of Mr. Justice Stone's philosophy appears in this sentence:

Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the ex-

[74] 311 U. S. 112 (1940). [75] 311 U. S. 122 (1940).

[76] *E.g.,* North Am. Oil Consolidated v. Burnet, 286 U. S. 417 (1932); Helvering v. Bruun, 309 U. S. 461 (1940).

[77] See, *e.g.,* Helvering v. Midland Life Ins. Co., 300 U. S. 216 (1937).

[78] Lucas v. Earl, 281 U. S. 111 (1930).

[79] Hall v. Burnet, 54 F.(2d) 443 (App. D. C. 1931) *cert. denied,* 285 U. S. 552 (1932); Rosenwald v. Commissioner, 33 F.(2d) 423 (C. C. A. 7th, 1929), *cert. denied,* 280 U. S. 599, 50 Sup. Ct. 69 (1929).

penditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son.[80]

A literal application of this doctrine might lead to the taxation to the settlor of the income of any trust. Conceivably it might justify the taxation to the donor of interest on bonds or dividends on stock given to the donor's wife or son. Probably, the decisions do not go so far. Bearing in mind that the income evidenced by the coupons had accrued wholly or partly in the donor's hands, the *ratio decidendi* might be no more than that indicated by Mr. Justice Holmes' metaphor in the *Earl* case: that an income tax cannot be escaped by anticipatory arrangements by which "the fruits are attributed to a different tree from that on which they grew." At any rate, the second Circuit Court of Appeals does not believe that the *Horst* decision "means that every settlor of a trust is taxable upon whatever part of the income is applied to purposes, the furtherance of which give him satisfaction."[81] By the same token, the *Eubank* case means that a man's earnings are necessarily taxable to himself, whether assigned before or after the work is done.

Since the decisions may be given a wider application than that advocated here, and since the stated definition of income goes beyond previously accepted standards, attention must be given them in nearly all cases in which there is or may be a question of the person to whom income is to be taxed. Finally, although the Court ostensibly distinguished the *Blair* case[82] (an assignment of income from a trust), these

[80] 311 U. S. at 117.
[81] Commissioner v. Chamberlain, 121 F.(2d) 765 (C. C. A. 2d, 1941).
[82] 300 U. S. 5 (1937).

decisions certainly restricted it greatly, as *Harrison v. Schaffner*[83] directly shows.

c. *Douglas v. Willcuts*[84] and *Helvering v. Clifford.*[85] Having determined years ago that alimony was not taxable to the divorced wife and not deductible by the husband,[86] the Court arrived without much difficulty at the conclusion that the income of a trust for the benefit of a divorced wife, sanctioned by the divorce decree, was taxable to the settlor husband.[87] The income was being used to meet his obligation to support established by the decree. In the same way, the income of trusts used to support minor children of the settlor is taxable to him.[88] Recently, taxpayers obtained a more discriminating analysis of the alimony-trust cases. Under particular state laws, the creation of the trust may constitute a complete discharge of the husband's duty to support, like the compromise of any other claim, so that the payments to the former wife cannot properly be regarded as payments in satisfaction of an existing pecuniary obligation of the settlor. If this legal situation could be established, the trust income was not taxable to the settlor.[89] The burden was not, however, an easy one to sustain.[90]

[83] 312 U. S. 579 (1941), holding that an assignment of dollar amounts by the life beneficiary to her children out of trust income for the year, did not reduce the income taxable to her.

[84] 296 U. S. 1 (1935).

[85] 309 U. S. 331 (1940).

[86] Gould v. Gould, 245 U. S. 151 (1917). This opinion also contains the now almost forgotten sentences, once quoted in every taxpayer's brief: "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions by implication beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." The *Clifford* decision, discussed in this section, indicates why the quotation is no longer apposite.

[87] This is the decision in the *Douglas* case.

[88] Helvering v. Schweitzer, 296 U. S. 551 (1935).

[89] Helvering v. Fuller, 310 U. S. 69 (1940).

[90] *Cf.* Helvering v. Leonard, 310 U. S. 80 (1940); Helvering v. Fitch, 309 U. S. 149 (1940).

The Senate proposed in 1941 that alimony and separate maintenance payments whether or not paid by a trust should be taxable to the spouse who receives them, and not to the other spouse.[91] The amendment was defeated in conference, but was adopted in 1942. There is much to be said for the application here of the general working rule that ordinarily income should be taxed to the recipient.

In *Helvering v. Clifford*[92] the Court held that the settlor was taxable on the income of a trust whose existence was limited to five years, after which the corpus reverted to the settlor, the settlor's wife being the beneficiary and the settlor trustee. The Court reached the result under Section 22(a), the general definition of income, at the same time holding that it could not be reached under the specific language of Section 166.[93] The Court brushed aside the argument that the general sections of the law were not capable of this construction since Congress in 1934 had neglected to act on the recommendation of the Treasury that short-term trusts be expressly dealt with. The majority opinion relied upon three factors: the short term of the trust, the fact that the beneficiary was the wife, and the retained powers of the husband-settlor.

The lower courts have since struggled to determine the application of variants of these factors in other cases. They have properly been regarded as complementary.[94] The likelihood of the settlor's success in close cases is not great. Even though the trustee is a trust company or outsider, the income is apt to be taxed to the settlor if the beneficiaries are members of the "intimate family group," and the settlor possesses

[91] H. R. 5417, 77th Cong., 1st Sess. (1941), as passed by the Senate, § 117; Sen. Rep. No. 673, 77th Cong., 1st Sess. (1941) 32. See Sec. 120, Rev. Act of 1942.

[92] 309 U. S. 331 (1940).

[93] Helvering v. Wood, 309 U. S. 344 (1940).

[94] Helvering v. Elias, 122 F.(2d) 171 (C. C. A. 2d, 1941), *cert. denied,* 314 U. S. 692, 62 Sup. Ct. 361 (1941).

some degree of control.[95] Substitute a term of less than five years for some control by the settlor, and the result has been the same.[96] The settlor has succeeded in cases where, though the term was three years and he was one trustee, the beneficiary was an educational institution;[97] and where the term was ten years, the trustee independent, and the beneficiary outside the family.[98] Thus the protective devices of powers of revocation, or alteration, or of other forms of control have been pretty well outlawed. We are steadily coming closer to the taxation of family income as a unit. If the joint-return proposal comes to pass, that end will have largely been reached.

d. *Higgins v. Commissioner.*[99] This decision upset a long era of departmental policy of allowing deductions for investment expenses of various kinds though not connected with a business. Had the Court been as willing to give deduction provisions a liberal interpretation in the interests of wise policy, as it has frequently been in the case of income provisions, the decision need not have been made. It was generally agreed that an amendment to Section 23(a) should be promptly adopted to obviate the decision; and to avoid the inequity of compelling investors in substance to pay a tax on their gross income while traders are taxed on their net. An appropriate amendment to this effect appears in Section 121 of the 1942 law.

Conclusion

A time of war is not a time for radical improvements in tax laws in the interests of equity, although a philosopher

[95] Commissioner v. Buck, 120 F.(2d) 775 (C. C. A. 2d, 1941).
[96] Commissioner v. Barbour, 122 F.(2d) 165 (C. C. A. 2d, 1941), *cert. denied,* 314 U. S. 691, 62 Sup. Ct. 361 (1941).
[97] Commissioner v. Chamberlain, 121 F.(2d) 765 (C. C. A. 2d, 1941).
[98] Commissioner v. Jonas, 122 F.(2d) 169 (C. C. A. 2d, 1941).
[99] 312 U. S. 212 (1941).

might suppose that, as legislators increase the tax burden, they would feel an increasing responsibility for improving the operation of the revenue laws. Actually, the legislative process does not operate in this way. The need for revenue is paramount and, since amendments in the interests of equity usually diminish the revenues, such amendments are not apt to be made except in times when the Treasury is under much less strain than it is now. Consequently, of the various changes suggested above, it is not very likely that many will be enacted into law in the next few years except those which will contribute directly to the Treasury. For somewhat similar reasons, technical experts, who are working with the very difficult task of devising statutes to raise more revenue than we have ever raised before, are not likely to find time to make many technical or administrative improvements. As a matter of fact, it is surprising that the 1942 law contained as many amendments in the interests of the taxpayer as it did.

The outlook for the immediate future then is not very hopeful from the point of view either of the objective student of taxation or of the taxpayer himself. It is evident that individual and corporate income tax rates may be further increased. The excess-profits tax rates have already reached a peak. The same process of increasing rates and lowering exemptions will doubtless be applied to the estate tax and to the gift tax even though their immediate revenue significance is not very great. A further increase in the scope and rates of excise and sales taxes is also in the cards. The principal administrative change may be the institution of a system of withholding income taxes on some of the commoner forms of recurrent income, such as salaries, wages, dividends, and interest. Withholding is provided by the 1942 law as the method for collecting the new 5 percent "Victory" tax, but not for the ordinary income tax. It is possible

that a correlation of the estate and gift tax might occur in time. On the other hand, a broad general revision of the income-tax law, or even of the reorganization provisions, is apt to wait until the present emergency is over.

The formulation of a well-integrated tax policy for the country, including of course the correlation of state and federal taxing systems, has long been one of our major neglected problems of government. It may be too much to hope that the Treasury will undertake to formulate such a program under the pressure of the emergency. It is not too much to hope that ways and means should be adopted now for the consideration and advancement of such a program to be carried into execution immediately after the termination of the emergency. To choose the personnel and to arrange the necessary collaboration between the Treasury, the Congress and the states is an enormous task, but it is one which will have to be performed if the country is ever to have the fair and intelligible tax system which will be a prime necessity after the war.

CHAPTER VII

FEDERAL TAX ADMINISTRATION

THE MULTIPLICATION of administrative agencies in Washington has caused great discussion of the place of these official groups in governmental organization. Many of them perform functions which could be severally catalogued as executive, legislative, and judicial. What price our historic separation of powers? Characteristically these agencies make and change their rules as they go along. Indeed a few years ago it was not always easy to discover what rules were in force and effect, until the Federal Register was established. The slogan, "A government of laws, not of men," expresses in an easily acceptable form the lay criticism of this form of governmental operation.

Criticism of this character has not been much directed, apparently, at the Bureau of Internal Revenue, notwithstanding that its extraction of billions of dollars from millions of citizens year after year can never be pleasant or popular. Few of us ever exclaim, with Mr. Justice Holmes' Olympian detachment, that we like to pay taxes, even though we may grudgingly concede that they are the price we pay for civilization. If the slogan of a government of laws not of men means that the administrative official must only carry out express statutory provisions, never extending them or making them more explicit by detailed rules and regulations, the Bureau certainly is a government of men. The

income-tax law on depreciation and depletion is only a few lines long; the Treasury Regulations and rulings on these subjects cover many pages. Voluminous as the statute has become (the Revenue Act of 1942 covered 208 pages in the official print), the current income-tax regulations interpreting one part of it form a book of 800 pages. More particularly, revenue agents are disposing of dozens of cases every day by compromise, asserting this point, conceding that, settling several thousand returns informally for every one that gets into the courts. There is much criticism today of the rigid attitude of Bureau officials in insisting upon pounds of flesh not clearly due, but their mode of procedure is not seriously atttacked, except as to details.

There may be a lesson in this for other administrative agencies. Bureau procedure follows an earlier pattern, whereby, first, power to make rules and regulations is specifically delegated to the Bureau in the tax statutes; and second, effective judicial review of tax determinations is clearly provided for. The aggrieved taxpayer can surely have his day in court if he wishes it. Indeed he can try his case afresh before a trial court, and then have an appeal as of right to a federal circuit court of appeals. Thus he has the fundamental protection of a judicial proceeding against arbitrary administrative action. Nor is this merely a theoretical protection. Thousands of tax cases have been heard by the federal courts and the Board of Tax Appeals every year. Tax controversies are by all odds the largest single category of cases heard by the Supreme Court. For these reasons among others, taxpayers generally do not cut corners in their dealings with the Bureau. The overwhelming majority of returns are honestly made. The Bureau can rely on taxpayer morale, even when, as at present, tax exactions are severe.

If a man from Mars were to observe the functioning of

the Bureau of Internal Revenue, he would find it engaged essentially in three kinds of tasks. In the first place, it must assess and collect around $25 billions from many millions of taxpayers, a full-time occupation for many thousands of employees. Next, like a court, it must hear and determine appeals in tax cases, deciding questions of fact and questions of law involving millions of dollars and an exceedingly complex technique. Finally, like a legislature, it must lay down rules of general application in tax cases—rules which the Congress has found it impractical or difficult or impossible to write into the statute itself. Each of these activities possesses major importance in our economy, an importance which has grown enormously in the thirty years of modern federal taxation since the adoption of the income-tax amendment. Not only are the sums involved great, but the consequences reach into most of the corners of our economic and social life. Tax questions lie at the heart of the creation of any trust, the preparation of any will, the organization of any corporation. Hence it is vital that the Bureau's procedure, and the procedure of reviewing courts should be fair, swift, and sure. If it is not so now, it is vital that we taxpayers should interest ourselves actively in making the necessary changes.

The discussion in this chapter will fall under two main topics: first, a description of the present administrative procedure for the collection of taxes and the court procedure for reviewing determinations of the Commissioner of Internal Revenue; second, an appraisal of the utility of the present methods, and of the major proposals for improvements. The essence of my conclusions is that the Bureau's administrative procedure in the unlitigated cases has on the whole kept adequate pace with the fortyfold increase in its task which has occurred since 1913—an increase in annual collections from $344 millions of internal revenue in 1913 to

some $13.6 billions in 1942, and an estimated $23.9 billions in 1943. During 1938, the Bureau adopted a program of decentralization of its offices, designed to give the taxpayer opportunity for a hearing in regional offices, rather than in Washington; and to provide for prompt, local settlements. In its operation to date, the plan has reduced considerably the backlog of old cases.

Judicial procedure for reviewing tax determinations needs consolidation and simplification. The creation of the Board of Tax Appeals in 1924 added a new tribunal to those already authorized to try federal tax cases. In eighteen years, it has acquired the great bulk of the litigation, but its jurisdiction is neither complete nor exclusive. Annoying conflicts in decisions among the various tribunals still occur, and the machinery for resolving them finally is not very adequate. There has been a good deal of recent discussion of possible improvements, some of which require comment.

Tax-Collection Procedure

It is customary to think of the Bureau as administering two or three taxes—the income tax, estate tax, liquor tax. Actually it administers about sixty. These range from levies on nearly thirty million income taxpayers to levies on a few cigarette manufacturers; from sharply progressive taxes on estates, gifts, and incomes to the multitude of flat-rate sales taxes. The income tax in fact produced 61.5 percent of the $13,029 millions which the Bureau collected in 1942. It will produce a much higher percentage of the total volume of litigation. For one thing, the number of income taxpayers is much greater than, for example, the number of distillers. In 1942, about twenty-six million individuals filed income tax returns, and about half a million corporations. The income tax applies not merely to distillers, to tobacco manufacturers, to refiners of oil and gasoline, to tire and

automobile manufacturers, each of whom has its own set of excises, but to lawyers and doctors, corporation executives and trust beneficiaries. More important is the fact that the income tax possesses inherently more technical difficulties than any form of sales tax. Every taxpayer is well aware of the complex legal and accounting problems involved in the determination of gross income and of deductions; problems many of which are unsettled after years of interpretative rulings and decisions.

Collection methods vary greatly with the different kinds of taxes. For present purposes, two major types may be noted. In the case of the taxes on alcoholic beverages, for example, the Bureau's agents are stationed in the distilleries and breweries themselves, with broad powers to enter and examine at all times "as well by night as by day." There are elaborate provisions to insure that the Bureau's agents are currently informed, not only of the materials used in making the taxable beverages, but in detail of the location and plan of operation of all the apparatus. Litigation over the amount of the tax is in the form of a suit to recover money already paid. Not many suits involving these sales taxes are actually brought. In other words, the Bureau's agents have immediate knowledge of any taxable transaction. Their determinations seem to possess a high degree of finality.

In the case of the income tax, on the other hand, the return is now made by the individual, the corporation, the partnership or the fiduciary two and one-half months after the close of the year in which the income was received. The taxpayer determines his own tax in the first instance. The Bureau's representatives have not been stationed in his office during the year; their check on the accuracy of the return is made months or years later. The collection of the income tax possesses some of the aspects of a game of hide and seek, in which the government is always "it," and good-

naturedly counts for a year or two before it starts to hunt. It would be miraculous if shrewd lawyers were not always a few steps ahead. If the Bureau finds an additional tax to be due, the taxpayer can contest it before payment; or he can pay it, and sue to recover it. The income taxpayer, then, is free from most of the supervision exercised over the alcohol taxpayer. The success of the administrative procedure depends to a much greater degree upon his coöperation.

The bulk of federal tax litigation has concerned the three modern progressive rate taxes: income, estate, and gift. To these has been added the excess-profits tax. Since most citizens come into direct contact only with these four taxes, and since they are the ones with which lawyers are chiefly concerned, this discussion of procedure is confined mainly to them.

Although some commentators have concluded that our methods produce too much tax litigation, the number of cases is indeed slight in comparison with the total number of returns made. To put the conclusion another way, the Bureau of Internal Revenue is reasonably successful in its tax determining and tax-collecting capacities, its quasi-judicial activities. As we have noted, over twenty-six million individual income tax returns were made in 1942, and around five hundred thousand corporation returns. The number of suits started annually in the Board and the courts has been around five thousand in recent years.[1] In other words, only one in several thousand income tax-returns resulted in litigation. To be sure, the litigated cases typically involve large amounts of tax, as well as complex questions of law. Further, the amount of litigation should probably

[1] In the fiscal year 1942, 153 suits involving income, estate, gift, and excess-profits taxes were filed in the Court of Claims, 475 in the district courts, and 3,676 in the Board of Tax Appeals. In 1941, the figures were, 85,589, and 4,336 respectively.

be reduced. Nevertheless, it is true that the Bureau disposes of the bulk of cases, both in number and in amounts.

Of the total individual income-tax returns (actually, 26,306,200 in 1942), about 95 percent show less than $5,000 net income, and about one-third are nontaxable returns. The bulk of them is disposed of in the 64 collectors' offices scattered over the country, generally by an office audit, but sometimes by an examination of the taxpayer's books as well. Those individual returns which show over $25,000 gross income, corporation returns showing over $75,000, and all returns as to which questions arise are audited by the 38 internal revenue agents' offices around the country. In the fiscal year 1941, 470,876 returns were given a field investigation. The field examination normally consists of a visit by an internal revenue agent to the taxpayer, a check of his books, and the submission of a report to the agent's superior. In a little less than half the cases examined, the agent finds that the tax has been underpaid. The taxpayer is notified of the detailed findings, and is entitled to a conference in the office of the internal revenue agent in charge. If no settlement could be reached there, the taxpayer under the old procedure was entitled to a further conference in Washington. As a matter of fact, the Washington conferences were apt to be numerous and time-consuming. Briefs and supplemental briefs, discussions of points of law, accounting and engineering were normally to be expected in the large cases. Through these conferences, the number of disputed cases was gradually sifted down, as the facts were more fully brought out, and the questions of law better considered.

The Treasury determined in 1938 to transfer the necessary technical personnel from Washington to regional centers over the country, there to perform the functions of investigating, settling, and, if necessary, of litigating cases which had not been settled in the internal revenue agents'

offices. Regional settlement offices were set up in ten districts, covering the whole country and its possessions. Investigations and hearings are ordinarily conducted in the taxpayer's own city, or in some adjacent center.

The procedure of the internal revenue agents in investigating tax returns has not been greatly changed. Upon the completion of the agent's work, the taxpayer is notified of any adjustments which the agent believes should be made. The taxpayer is entitled to a conference with the agent, in order to settle the differences between them, if possible. In most instances, the controversy will end at this stage, by the acceptance of the return as filed, the payment of an additional tax, or the allowance of a refund.

If after hearings the taxpayer is still dissatisfied with the agent's conclusions, he may protest them. The case will then be referred to the local division of the technical staff. The staff, an agency of the Bureau of Internal Revenue, has two functions: to settle controverted cases, if possible; and, if not, to make the final administrative determination with respect to all matters in dispute, subject only to appeal to the Tax Court[2] and the other federal courts. In the appeals to the former, attorneys assigned to the regional offices who have been called in on any legal questions arising in the technical staff's consideration of the case will have the responsibility for trying it.

Several economies result from the new procedure. In the first place, the facts can certainly be better determined in the field than in Washington, at less expense to the taxpayer and to the Treasury. Again, the Bureau is charging a single group of men with the responsibility for handling a case from the time it leaves the internal revenue agent until it is settled or the trial before the Tax Court is concluded—the

[2] The Rev. Act of 1942 (§ 504) changed the name of the Board of Tax Appeals to "The Tax Court of the United States."

same type of responsibility that the businessman under similar circumstances places upon his lawyer. If the facts are badly prepared, if unjustified deficiencies are asserted, if trials are botched, there is little difficulty in fixing the blame. Again, decentralization makes available to the taxpayer with small income, as well as to the one with large, an opportunity for an administrative review by well-trained officials in a local office. The Bureau had good reason to believe that better settlements, less litigation, and better tried cases would result from the new procedure. Decentralization of the Bureau's activities has proven to be the most important reform instituted in federal tax procedure in many years.

Regulations and Rulings

The function of interpreting the revenue laws for the information of taxpayers, generally, might have been regarded as merely incidental to its function of determining and collecting taxes. On this basis, it might have been surrendered in large part by the Bureau to the Board of Tax Appeals and the courts. For example, the manual generally used by Inland Revenue Officials in Great Britain is not, as in this country, the Treasury Regulations, but a fat volume containing the text of the income-tax law, annotated section by section with applicable court decisions.[3] The federal administration, however, unlike the state, has given its interpretative functions paramount importance.

Treasury Regulations contain essentially three types of subject matter. There are, first, requirements as to administrative procedure, the forms to be used, books and records to be kept, the time and place of filing returns. The Commissioner must give the taxpayer guidance in these respects, and, more important, his conclusions are authoritative and

[3] DOWELL, INCOME TAX LAWS (9th ed., Butterworth, 1926); and Second Supplement, H. M. Stationery Office, 1933.

not reviewable. In the second place, certain sections of the law specifically provide that such computations as the depletion allowance shall be made under rules and regulations prescribed by the Commissioner. Here also an advance publication of rules is required, and, in the absence of an abuse of discretion, the rules are not reviewable. Finally, there is a vast amount of interpretation of provisions of the law which confer no specific powers on the Commissioner, such as, for example the regulations relating to the types of trusts which the Commissioner deems to fall within the wording of Section 166 of the law.[4] Regulations of this sort have no special sanctity; the federal courts are the final arbiters of the meaning of the law. If the Commissioner is merely digesting authoritative court decisions, his regulations are a convenient textbook, though careful lawyers will certainly examine the decisions themselves. If he anticipates the decisions and places a construction on the law of doubtful validity, he is certainly rendering no service to taxpayers, and it is at least questionable whether he is facilitating good administration. It would be better to wait until actual cases arise and are litigated, and an authoritative interpretation is thus reached.

Federal revenue laws today are not the *terra incognita* which the income tax was thirty years ago. Experience is much more widespread; and, more particularly, there are many volumes of judicial decisions, and of excellent texts interpreting the law. There is not the same need for elaborate interpretation of the law by the Treasury. The Treasury delayed two years in issuing estate-tax regulations interpreting the important amendments made in 1932, and Rome did not fall. The existence of extensive interpretative regulations—Regulations 103 on the income tax runs to 787 pages, with a 74-page Index—takes the attention of subordinate Bureau employees away from the law itself, and the decisions

[4] U. S. Treas. Reg. 103, Sec. 19. 166–1.

of the Supreme Court upon it, although these are really the primary authorities. In the second place, it is worth noting that the genius of the common law was that it decided the particular case as that case came up on the facts then presented; it did not attempt to lay down general rules for all cases, before the facts had been fully developed. To be sure, what had been decided in one case was frequently applied to others involving closely similar facts; but variations in facts might well cause the court to distinguish the prior case and to work out a different result. The Bureau could take a leaf from this book, so far as its purely interpretative regulations are concerned.

The administrative point of view, which leads to the publication of elaborate interpretative regulations, is exemplified further in the publication of Treasury rulings in particular taxpayers' cases, whenever those rulings are deemed to have general significance. In the course of about twenty-four years, some forty-five volumes of such rulings have been published, and the rulings are still appearing in a weekly pamphlet. The underlying theory is, of course, that every taxpayer should be given the advantage of any ruling of general application made in another's case. No one could quarrel with the fairness of this philosophy. It has at least two disadvantages, however. Subordinate Bureau officials tend to overemphasize the importance and the correctness of the published rulings of their superiors. Subsequent court decisions may indicate that the ruling is incorrect, but it will usually be given great weight until it is formally overruled. Again precedent and consistency in ruling are often regarded as more important than the fair compromise settlement of the particular case. Note that both of these failings are matters of emphasis; Bureau officials cannot be said to be wholly wrong in their attitudes. Nevertheless, the utility of publishing rulings in individual cases seems pretty dubious in these

days. No one outside the Bureau gives them much weight, for they have none of the force of finality of court decisions or even of regulations. There is plenty of available authoritative material today. Bureau rulings, in general, muddy waters already heavily laden.

Personnel

The major problem in tax administration, as in running a business, is the selection and retention of able personnel. The problem has various facets, one of the most important of which is training men to serve adequately in the two conflicting capacities of prosecutor and judge. A good representative of the Bureau, particularly in the upper reaches of its service, must be at once zealous to uphold its interests, and even-handed in disposing of controversies to which the government is always a party, and in which large amounts are frequently involved. The proper functioning of the Bureau requires, not only that 99.9 percent of all revenue cases be disposed of without litigation, but that they be intelligently disposed of. The job is inherently more difficult than a judge's. The Bureau official must interpret the statute as a whole (in regulations), not merely the little segment of it that will be involved in a particular case. The regulations necessarily fill in hundreds of the blanks found in the statute, some of them highly important ones. The official is always concerned with long-run policy: what will work best administratively, and what is fairest to both parties, granted the mandate to raise revenue by the particular tax. So it frequently falls to the lot of the official to formulate and recommend legislation primarily for the benefit of the taxpayer, in cases in which the existing law, as courts interpret it, is operating harshly or unwisely. The official has the burden, which the court does not fully share, of maintaining the tax laws in as workable and equitable a form as he can, by inter-

pretation when interpretation will suffice, by recommendation of amendments, if interpretation cannot go far enough.

The fact that money is always at stake, and often a lot of it, increases greatly the difficulty of the administrative process. Taxpayers are prone to believe, whatever the justification, that revenue agents are promoted on the basis of the amounts of additional taxes determined, as salesmen might be on the basis of volume of orders. If the controversy involves a hundred thousand dollars or a million dollars, can an administrative official, especially one in the lower reaches of the hierarchy, be expected to decide it in favor of the taxpayer, unless the merits of his case are crystal-clear? Out of the multitudinous precedents, there must be some which to some degree sustain the Bureau's position. In any event, why not let the taxpayer take the case to a federal court? If the Bureau decides in his favor, a court decision will not be obtained, but if it decides against them, frequently he will seek some form of judicial review. Finally back of the decision by a subordinate of every sizable case, stand specters of disapproval by superiors or even by Congress. It is a commonplace in Washington and doubtless in the field that a revenue agent will never get into trouble by saying no.

Yet it is still true that the success of the revenue service depends upon prompt and fair disposition of the thousands of cases before it, with judicial determinations only in the toughest controversies. Moreover, since taxes are so largely self-assessed, and since in these days, many of the taxpayer's entries on his return cannot possibly be checked, revenue administration will fail if the taxpayer does not have a good deal of confidence in the uprightness and the fairness of Bureau agents and officials. On the whole, taxpayers do have confidence in the honesty of the field force, for cases of bribery and venality have been amazingly few. They are not quite so sure that the role of the agent and official as prose-

cutor is not more assiduously played than his role as judge. Few expect to win a hard case involving a considerable amount of money in the agent's office or even in the technical staff. The best hope is of a compromise involving a payment of additional taxes.

It is difficult, however, to see how the situation can be greatly improved by any procedural or mechanical device. Essentially good administration turns on good men. The Bureau is quite nonpolitical, with the exception of the Collectors' offices; and the turnover is not as great as is generally supposed. There are an astonishingly large number of first-rate men in the Bureau, who have served for years at quite modest salaries, resisting the lure of greater incomes and independence outside. Their number could be increased by two devices. In general, the Bureau and the Civil Service Commission have been slow to take steps to bring into the service young men newly graduated from professional schools. Such men have no experience, but increasing numbers are anxious to work on the governmental side of the street. Many of them would grow into fine civil servants. We can and should develop more of a tradition, in the Bureau as in the State Department, of the revenue service as a career for top-notch men. The second device flows from the first: salary scales need to be revised and increased, so that the man of first-rate ability can expect in due course to obtain and to hold a secure and responsible position with remuneration adequate to his years. Salaries need not match those of corresponding positions in business, but they should be considerably better than they are today. Certainly, the government can well afford to match the salary scale, say, of our best universities. A salary of $15,000 a year for the deputy commissioner in charge of the income-tax unit is certainly not excessive for the training and responsibilities required. It would operate not only to secure and hold a good incum-

bent, but to encourage a hundred young men to work up to posts of similar importance. The standard Washington basis for salaries—that they must be gauged to a top not in excess of the Congressman's $10,000—does not seem very rational. Americans ought to be intelligent enough to abandon it.

Court Procedure in Tax Cases

During the fiscal year 1942, 3,676 appeals were filed with the Board of Tax Appeals and 628 suits by taxpayers in the federal district courts and the Court of Claims. All three tribunals have original jurisdiction in federal tax cases, but there are numerous small differences in jurisdiction, pleading, and procedure. If the taxpayer has paid the disputed tax, he may have recourse either to a federal district court or the Court of Claims, but not to the Tax Court (formerly the Board). If he has not paid the tax, his recourse is only to the Tax Court. The party defendant in his petition to the Tax Court is the Commissioner; in the other federal courts, he sues the Collector, the Collector's personal representative, or the United States. Before the Tax Court, or the Court of Claims, he is not entitled to a jury trial; if he is suing a collector, he is. Hearings in Court of Claims cases may be conducted before a commissioner of the court; hearings before the other two tribunals will be heard by the judges themselves. No appeal of right lies from a Court of Claims decision. Appeals of right from Tax Court or district-court decisions lie to one of the ten Circuit Court of Appeals, or to the Court of Appeals of the District of Columbia. There is no appeal of right to the Supreme Court. Thus there is every opportunity for conflicting or inconsistent decisions by the initial and appellate tribunals.

These procedures possess several noteworthy characteristics that are interesting to a student of administrative and judicial tribunals. In the first place, evidence in all three

types of proceeding must be introduced *de novo*. None of them is certiorari based on a finding of facts by the Commissioner of Internal Revenue. Before the Tax Court, the Commissioner's determination enjoys a presumption of correctness, but it is fully subject to review, and the Court makes its own findings of fact. In other words, the question is not at all whether there was evidence on which the Commissioner could reasonably have reached his conclusions. The scope of the review of his decision is wide and complete. The pendulum has swung far away from the more usual procedure for review of administrative determinations in this field in which prompt action is so vital to the government. Were it not for the single fact that the Commissioner of Internal Revenue is perforce adversary party as well as judge in proceedings before him, there would certainly be reason for recommending that his findings of fact have greater weight in tax cases, and that the scope of review be restricted.

Second, the present Tax Court, although created as an independent agency in the executive branch of the government, and pretty clearly intended originally to serve as a group of conferees to resolve disputed tax cases around the table, has adopted the procedures of a court. In practice it has taken no responsibility whatever for the settlement, as distinguished from the trial, of tax cases, although it has been continuously confronted with more appeals than it could possibly hear under the strict judicial procedure it deliberately follows. In this respect, the Tax Court differs from the corresponding British tribunal, the Special Commissioners of Income Tax. The Bureau therefore of necessity has assumed the burden of settlement. Thus, in 1942, there were 3,676 appeals to the Board, a comparatively small number. During the same year, 4,292 petitions were disposed of, 1,594 on the merits and 181 by default. Meantime the various agencies of the Bureau settled 2,517 appeals, thereby

serving to reduce the backlog of untried Board cases to its lowest point.

The Tax Court has its own rules for admission to practice, for formal pleadings both by petitioner and defendant, and it applies rules of evidence. A hearing before the Tax Court is very like a trial before a federal court; and the formalities and delays incident to a judicial proceeding have appeared in full measure. In the past, a year or two has elapsed between the filing of a petition and hearing, and six months or more between hearing and decision. The efforts of the present Court, and particularly of its chairmen, have improved its calendar practice, and have shortened these periods somewhat.

The Tax Court normally makes extensive findings of fact, and writes a long opinion, not merely a brief judgment determining the controversy. It has issued 47 volumes of reports since its establishment in 1924. The Supreme Court has treated it like an administrative body, in that it has been given broader powers of review than the federal courts have. In reality the Board utilized few of the advantages of such a body, such as, for example, informal procedure, and investigations and settlements initiated by itself. Perhaps it is as well that the Board played the role it has, and that the Bureau should retain and exercise sole administrative responsibility in tax cases. In any event, the Bureau has built up the machinery for hearing and for settling cases administratively; and now has moved to make it available to the taxpayer in his own locality. If this machinery continues to work well, the part of wisdom would be to develop it in its present setting, not to insist upon its transfer to another administrative institution. Moreover, since the Tax Court is performing the functions of a specialized federal court, its actual status might properly be recognized by converting its members into federal judges, with the life tenure and pen-

sions now enjoyed, for example, by the judges of the United States Customs Court and of the Court of Claims. This change in status and tenure would work no change in the actual functioning of the Tax Court, but doubtless would assist in securing and in retaining well-qualified men.

We then confront the question—are three kinds of federal courts and procedure essential in tax cases, with in fact 87 different tribunals, and 11 different courts to which appeals may be taken as a matter of right?

At the present time, it is impossible to obtain a really authoritative decision of general application upon important questions of law for many years after the close of any taxable year. The average period between the taxable year in dispute and a Supreme Court decision relating thereto is nine years. Meanwhile confusion reigns in the day-by-day settlement of the more debatable questions of the tax law. One circuit court holds that a certain situation gives rise to tax liability; another circuit holds the contrary. The Commissioner and the lower federal courts are both confronted with the problem of reconciling the irreconcilable. A great part of the criticism of changing interpretations of the law announced by the Commissioner of Internal Revenue is properly attributable to the multitude of tribunals with original jurisdiction in tax cases, and to the absence of provision for decisions with nationwide authority in the majority of cases. If we were seeking to secure a state of complete uncertainty in tax jurisprudence, we could hardly do better than to provide for 87 Courts with original jurisdiction, 11 appellate bodies of coördinate rank, and only a discretionary review of relatively few cases by the Supreme Court.

The checkered history of the taxation of income from property left in trust to the testator's widow in lieu of dower is a monument to the difficulty of securing an authoritative final determination of a nice question of law. In one forum

or another, the problem was in litigation for over a dozen years, at great cost to taxpayers and to the government. The Court of Claims, the district courts, and the circuit courts of appeals in three circuits, and the Supreme Court were called upon serially to decide it. Surely we can device a simpler, less expensive means for the final determination of questions in what has become one of the most important types of litigation.

Local agencies can perform more effectively the functions of investigation and settlement of tax controversies. A tribunal sitting locally can try the facts more economically than one sitting in Washington. Since the ascertainment and analysis of the facts and the law in a tax case is a task requiring a high degree of specialized competence, it seems preferable to assign a group like the Tax Court to try the cases initially and locally; and in the long run to relieve the federal district judges, charged with the responsibility of hearing a wide variety of other cases.

A gradual shift of this kind is actually taking place at the instance of tax lawyers, even without any express statutory blessing. The number of appeals filed with the Board in the fiscal year 1942 was about six times the number of suits filed in all other federal tribunals having jurisdiction; in 1941, more than six times as many appeals were filed in the Board as suits in the federal courts. If the Tax Court were given jurisdiction of claims for the refund of income and estate taxes, as well as of appeals from the determinations of tax deficiencies, it is likely that the number of suits filed in the federal courts would further decline. This step should now be taken by appropriate legislation. The Tax Court is quite as well qualified to handle refund cases as deficiency cases; and the increased flow of work would not be unduly burdensome. For the present, the district courts need not be expressly deprived of their jurisdiction in federal tax cases, for

the natural drift of cases to the Tax Court will ultimately achieve the desired result, without the wrench which a statutory deprivation of jurisdiction at this time would cause.

No one would advocate a shift in jurisdiction to try tax cases from the federal courts to the Tax Court, unless the latter is prepared to provide at least as regular, prompt, and convenient local hearings as are now provided by the district courts. The Tax Court has greatly improved its calendar practice in recent years. It now sets about 95 percent of its proceedings on circuit calendars. In cities like New York and Chicago, calendars are set almost continuously through the fall, winter, and spring. The actual practice is to prepare a calendar for two-week periods, with an intervening break of a week or two. In three other cities, Washington, Pittsburgh and Philadelphia, calendars are set for each of the three terms; in 15 other cities, for two terms a year; and in 27 others, for at least one term a year. Special calendars are arranged to dispose of any accumulation of cases, in these or other cities, or to handle large cases the trial of which will take several days or weeks. The fact that the Tax Court has a central headquarters, and that any of its 16 judges may be assigned to hear cases in any part of the country as occasion demands makes for flexibility in disposing of business, as well as for uniformity of decisions. The Tax Court is now more nearly current with its work than at any time since its establishment in 1924, with a backlog of approximately 5300 proceedings, of which 600 have been tried and submitted, and 200 await the entry of formal orders. The time is not far off when each proceeding can be set down as soon as the answer is filed for hearing on a definite and not far distant date. Settlement negotiations are greatly facilitated when the day of trial is no longer a remote possibility, but a rapidly approaching certainty. Good calendar practice lies at the heart of any procedural reform.

It has been suggested that, if tax cases are regularly to be tried in the taxpayer's locality, appeals might fairly be concentrated in a single appellate court. In this way, certainty and finality in the interpretation of tax statutes could be achieved more promptly than is possible so long as 11 different tribunals are given appellate jurisdiction. This court might be either a new court established for the purpose, or the Court of Claims or the Court of Appeals for the Dictrict of Columbia, with such additional personnel as might be necessary to handle the added burden. Another interesting and more drastic proposal is to set up an administrative court, one of whose parts would be composed of the members of the Tax Court. The district courts and Court of Claims would be deprived of jurisdiction in federal tax matters; and appeals would be heard by an appellate division of the same court, not by the circuit courts of appeals, subject to final review by the Supreme Court.

With the objectives of these plans, all of us would agree. It must be recognized, however, that there is some gain in having appeals in tax cases (as distinguished from the original hearings) considered by an unspecialized judicial tribunal, adequately informed of the developments in other fields of law which are enmeshed with tax problems. Conflicts arise which cannot be quickly resolved; but the ultimate result may be the better for the longer and broader consideration. There is a close balance between these factors on one side, and on the other side the advantages of the simplified procedure of a local hearing by a judge of the Tax Court, then appeal as of right to a single, authoritative court, and, finally, review by the Supreme Court in cases of major importance. To a tax administrator, the latter advantages have the greater appeal, for he would like to achieve finality in decisions more promptly than is possible now. Moreover, there is something anomalous about a procedure whereby

the decisions of a single trial tribunal may be reviewed by 11 courts of appeal. Nevertheless, my judgment would be that the proposed centralized appellate tribunal is not a wise reform at this time.

An Administrative Code

The outlined improvements in court procedure suggest a broader project: a revision of administrative provisions generally, and their restatement in an administrative code. Our provisions for the assessment and collection of the income tax and estate tax have been grafted on to the much older body of law for the assessment and collection of liquor and tobacco taxes. On the whole, the new and the old provisions fit satisfactorily, but frequently conflicts and ambiguities have resulted. Moreover, the older provisions need to be brought down to date, and to be simplified where that is possible. It is a tremendous job, for thousands of sections are involved, and many of them have been the subject of elaborate judicial interpretation. Nevertheless, it is a job which must be done sometime, for the sake of efficiency and economy in tax administration.

The Treasury began in 1937 the task of preparing a modernized and simplified administrative code. The initial draft has been completed, and has been published and circulated among lawyers and other persons who are experienced in this field. Criticisms have been amazingly few,[5] for the work was expertly done by an unusually good staff. This project is distinct from the codification of the internal revenue laws, carried to completion in 1939 by the staff of the Joint Congressional Committee on internal revenue taxation, with the aid of the Treasury. The latter codification combined into a single 500 page book the internal revenue laws which

[5] See a good analysis in Geary, *The Proposed Internal Revenue Administrative Code* (1942) 20 TAXES 390.

had been previously scattered in various statutes, but made no changes in substance or improvements in the law. The Internal Revenue Code was promptly adopted and has been a great convenience. The Treasury's proposed administrative code is designed to simplify and to improve, not merely to codify. It ought to be promptly adopted also, but whether it will be depends very largely upon the attitude of the bar. Only lawyers can have much interest in procedure matters, and most of them are apt to be indifferent. Nevertheless, the adoption of the new code would be an additional step toward reducing the high cost of paying taxes.

The growth in number and importance of administrative tribunals and agencies has been a commonplace of recent years. As time goes on, we are coming to appreciate better the roles that such agencies can play in various fields of law. The roles are quite diverse; there is about as much divergence as there is similarity between the operations of the Interstate Commerce Commission or the Securities and Exchange Commission and the operations of the Bureau of Internal Revenue. The Bureau, to its great credit, has met rapidly increasing responsibilities with a procedure which has kept its work fairly current, and with a personnel which has a good record for honesty and effectiveness. The great need of the Bureau, as of other Washington departments, is for better methods of recruiting and retaining intelligent men in its higher administrative posts. Since the government after the war may be much the greatest employer in the country, and since the revenue service is in many ways at once the most difficult and the most important operation of government, maintenance and improvement of it will continue to be a major concern of every citizen.

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